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No. _____

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1988

JAMES HELBA, JR.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

HENRY W. WALTHER
JOHN D. HUMBERT
DEERING, WALTHER & SANDS
2444 Wilshire Boulevard, Suite 301
Santa Monica, California 90403
Telephone: (213) 453-1941

and

RUSSELL IUNGERICH and
RUSSELL IUNGERICH
A Professional Law Corporation
3580 Wilshire Boulevard, Suite 1920
Los Angeles, California 90010
(213) 382-8600
Attorneys for Petitioner
James Helba, Jr.

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

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QUESTIONS PRESENTED

1. Have the Third Circuit and the Tax Court in this case improperly expanded the economic substance doctrine formulated by this Court so that transactions which have independent economic purpose and effect are treated as shams?

2. Does the published Tax Court decision affirmed by the Third Circuit in this case conflict with both Fourth Circuit precedent and the prior decisions of this Court?

LIST OF PARTIES

The parties to the proceedings below were petitioner JAMES HELBA, JR., and the respondent, the COMMISSIONER OF INTERNAL REVENUE, both named in the caption of this petition. These same parties are the only parties in these certiorari proceedings.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED i

LIST OF PARTIES ii

OPINIONS BELOW 1

JURISDICTION 2

STATUTES INVOLVED 3

STATEMENT OF THE CASE 3

A. Taxpayer's Very Real Economic Motivation for Entering into the Partnerships 3

1. His Intensive Investigation of the Videotape/Videodisc Market for its Investment Potential 3

2. Taxpayer's Investigation of the Market for Children's Programming 6

3. Taxpayer's Investigation of the Market for Cultural Programming 7

B. Production of the Videotapes 8

1. The Children's Videotapes 8

2. The Shakespearean Videotapes 8

C. The Economic Reasons Why the Purchase Transactions Were Structured as They Were .. 9

D. In This Case, the Promissory Notes Were Recourse Obligations Which Had Economic Substance and Were Not Shams 16

E. The Tax Court's Decision 18

F. The Third Circuit Appeal 19

TABLE OF CONTENTS–Continued

Page

REASONS FOR GRANTING THE WRIT 19

I THE TAX COURT'S DECISION THAT THE PARTNERSHIPS' PURCHASES OF THE VIDEOTAPES LACK ECONOMIC SUBSTANCE AS AFFIRMED BY THE THIRD CIRCUIT GREATLY EXPANDS THE PARAMETERS OF THE ECONOMIC SUBSTANCE DOCTRINE BEYOND THOSE CONTEMPLATED BY THE DECISIONS OF THIS COURT..... 19

II THE THIRD CIRCUIT'S DECISION IN THIS CASE CONFLICTS WITH DECISIONS OF THIS COURT AND THE FOURTH CIRCUIT 24

CONCLUSION 27

APPENDIX A – THIRD CIRCUIT JUDGMENT ORDER ..... App. 1

APPENDIX B – TAX COURT SUPPLEMENTAL MEMORANDUM OPINION FILED OCTOBER 19, 1987..... App. 4

APPENDIX C – TAX COURT OPINION FILED OCTOBER 30, 1986 ..... App. 11

TABLE OF AUTHORITIES

Page

CASES

Avers v. Commissioner, 55 T.C.M. 678 (1988) 21

Bridges v. Commissioner, 325 F.2d 184 (4th Cir., 1963) 21, 25

Falsetti v. Commissioner, 85 T.C. 332 (1985) 18, 21

Fox v. Commissioner, 82 T.C. 1001 (1984) 21

Frank Lyon Co. v. United States, 435 U.S. 561 (1978) 20, 23, 25

Goldstein v. Commissioner, 364 F.2d 734 (2nd Cir., 1966) 21, 25

James Rose v. Commissioner, 88 T.C. 386 (1987) 21

Knetsch v. United States, 364 U.S. 362 (1960) 20, 25

McCain v. Commissioner, T.C.M. 1987-285 21

Rice's Toyota World v. Commissioner, 752 F.2d 89 (4th Cir., 1985) 21, 24, 25

STATUTES

Internal Revenue Code

§ 183 22

§ 6213 2

§ 6214 2

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Petitioner James Helba, Jr., respectfully prays that a writ of certiorari issue to review the Judgment Order of the United States Court of Appeals for the Third Circuit, entered in the above-entitled proceeding on September 9, 1988.

OPINIONS BELOW

The United States Court of Appeals for the Third Circuit issued an unpublished Judgment Order without

opinion. This Judgment Order is reprinted in Appendix A to this petition.

The United States Tax Court (Nims, J.) filed two opinions in this case on October 30, 1986, and October 19, 1987. This October 30, 1986, opinion has been reported as 87 T.C. 63 (1986). These two Tax Court opinions are reprinted in Appendices B and C to this petition.

JURISDICTION

Invoking federal jurisdiction under sections 6213 and 6214 of the Internal Revenue Code, petitioner Helba filed petitions in the United States Tax Court for redetermination of income tax in response to respondent Commissioner's issuance of three statutory notices of deficiency. The Tax Court rendered its final judgment against petitioner Helba on October 19, 1987. *See* App. B to this petition.

On September 9, 1988, the Third Circuit entered a Judgment Order affirming the Tax Court. *See* App. A to this petition. No petition for rehearing was sought.

On November 28, 1988, Justice Brennan ordered that the time for filing this petition for writ of certiorari be extended to and including January 7, 1989.

The jurisdiction of this Court to review the judgment of the Third Circuit is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES INVOLVED

This petition does not involve the interpretation or construction of any statutes.

STATEMENT OF THE CASE

This case involves the appropriate federal income tax treatment of four Pennsylvania limited partnerships entitled Children's Fantasy, Limited ("CFL"), Geppetto's Music Shop ("GMS"), Merry Wives, Limited ("MW") and MacBeth, Limited ("MB"), collectively referred to as the "Partnerships". In all of these Partnerships, petitioner Helba (hereinafter "taxpayer Helba") acted as general partner or co-general partner. Taxpayer Helba was, and is, a Certified Financial Planner, and he has been the president and an officer of the Pittsburgh Association of Financial Planners in Pennsylvania. [App. 1507.][1]

A. Taxpayer's Very Real Economic Motivation for Entering into the Partnerships

1. His Intensive Investigation of the Videotape/Videodisc Market for its Investment Potential

In 1978, taxpayer Helba attended a convention of the International Association of Financial Planners where, among other investment opportunities, firms were marketing videotape programs. Taxpayer Helba spoke to several people regarding investment in videotape product,

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[1] The abbreviation "App." refers to Appellant's Appendix before the Third Circuit.

but decided that he would not then recommend that his clients invest in videotapes at that time. Taxpayer Helba also reviewed *The Wall Street Journal, Fortune, Newsweek,* a report by Smith, Barney, Harris, Upham and other publications which projected that the sale of videocassette recorders or videodisc players (collectively "hardware") and pre-recorded videotape or disc product would be a multi-billion dollar market in the 1980's. [App. 1401-19, 1511-1513.] Because Sony, Magnavox and RCA were offering competing and different hardware, and taxpayer Helba was uncertain which type of hardware would ultimately be the most successful, he determined that he would invest in the entertainment product which could be employed with any of the different hardware configurations. [App. 1509.] Taxpayer Helba believed that even given a small percentage of this multi-billion dollar industry, there was a significant profit potential in videotape investments. [App. 1512.]

In November, 1978, taxpayer Helba contacted Century Video Corporation ("Century") at the suggestion of one of taxpayer Helba's colleagues. Century was an independent producer located in Beverly Hills, California. Its principal officers and shareholders during the period in question were Lawrence Scheer and Leonard Francoeur. After meeting with Scheer, taxpayer Helba felt comfortable with Scheer's reputation and with his objective of creating a library of videotapes geared to what was perceived by both as a gap in the entertainment market, namely children's programming and cultural programming. [App. 1510, 1512.]

In 1976, Scheer and his brother had met with Sony representatives in Japan to discuss the possibility of

obtaining an exclusive license to import Sony VCR's into the United States. Scheer was unable to obtain the license from Sony because he was unable to raise the necessary capital. While in Japan, Scheer concluded that the VCR would create a new worldwide industry. [App. 1607-10.]

During the next year and one-half, Scheer investigated the feasibility of getting involved in the production of videotape or videodisc product for this emerging industry. To this end, Scheer visited manufacturers of videotape and videodisc machines in order to determine when the machines would be introduced and discussed programming with representatives of the three major networks and motion picture producers. After these discussions, Scheer determined that he would produce four types of programming for the home video market: Children's programming, cultural programming, educational or "how to" programming and music programming. Children's programming was chosen for several reasons, including the fact that many lobby groups, PTA's and other parent groups were complaining of violence on children's programming and poor quality indicated that there was some dissatisfaction with existing children's programming. Scheer believed that when the home video market matured, parents and grandparents would want to purchase nonviolent programming like musical comedies where the storyline taught a moral lesson. [App. 1610-13.]

2. Taxpayer's Investigation of the Market for Children's Programming

Taxpayer Helba chose to finance the production of a children's series because he believed that it would have a broad appeal and produce profits for his investors because of its timeless nature. [App. 1526.] Taxpayer Helba believed that the shortage of children's product was due to the fact that investors were usually after high glamour entertainment product and were interested in quick profits. He also believed that children's programming produced income steadily over a long period of time. [App. 1527.] Taxpayer Helba aimed at the preschool market because he thought that it was in need of product and because market penetration would be easier due to lack of alternatives. [App. 1527.] Taxpayer Helba believed that alternatives to pre-recorded videocassette programming generally consisted of reruns of old programming and nonsensical, violent programming. Emerging industries such as cable, pay television, and home video would, for the first time, give parents a choice in children's programming. [App. 1555.]

Taxpayer Helba discussed the marketability of children's programming with an independent agent, Richard Minken ("Minken"). For several years, Mr. Minken had acted as a distributor of many types of programming, including children's programming, in various markets. Taxpayer Helba and Minken discussed the fact that in 1974 the F.C.C. had issued a stern warning to the television industry to produce more programming for children. Minken stated that there was a need for children's programming and that it could be very profitable. [App. 1519, 1520.]

Taxpayer Helba toured the studios of Solaris International Pictures ("Solaris"), located in Santa Monica, California, who was to be the producer of the videotape series. Solaris provided a complete production facility including creation, writing and scoring of the product, producers, directors, cameramen, set construction, wardrobe, editing, sweetening, special effects and other post production services. Solaris began producing television product in the mid 1970's and had produced over 2,000 television shows when contacted by taxpayer Helba. [App. 1518, 1572, 1558, 1559, 1569, 1573.]

3. Taxpayer's Investigation of the Market for Cultural Programming

In 1979, taxpayer Helba received a marketing study prepared by R. Thad Taylor, President of the Shakespeare Society of America ("SSA"), which indicated that there would be a substantial market and substantial revenues for a videotaped and videocassette version of a Shakespearean play. The study was based on an analysis of various percentage penetrations of different markets in the United States and abroad, at a $3.00 royalty per cassette sold, and projected Partnership income of between $3,665,894.00 and $6,696,467.00 depending on the market penetration level. [App. 1135, 1400(a)-(j).] Taxpayer Helba received enthusiastic responses from various universities and professors in the Pittsburgh area regarding the marketability of authentic renditions of Shakespearean plays to schools and libraries. [App. 1514-17.]

Taxpayer Helba believed that there was a shortage of cultural programming available in 1979 and that producing product for the cultural market could be profitable

because it was a market which the major studios probably would not enter. The concept behind the Shakespeare productions was to provide an authentic rendition of a Shakespearean play on a set which would closely replicate the Globe Theatre, but to use actors speaking in a more American rather than English idiom to make it more understandable to people in the United States. [App. 1542, 1626.]

B. Production of the Videotapes

1. The Children's Videotapes

In 1979, CFL and GMS financed the production of two thirteen-episode children's series on videotape entitled "Memoirs of a Fairy Godmother" ("Memoirs") and "Geppetto's Music Shop" ("Geppetto's"), respectively. In October, 1979, CFL acquired all rights to Memoirs from Justin Pacific V, ("JP V") a wholly owned subsidiary of Century, who was the executive producer. GMS acquired all rights to Geppetto's from Justin Pacific II ("JP II") another wholly owned subsidiary of Century. [App. 1110-23, 1167-80.]

2. The Shakespearean Videotapes

In December, 1979, a videotape of Shakespeare's "The Merry Wives of Windsor"("Merry Wives") was produced by SSA for Bard I, Inc. ("Bard I"), a wholly owned subsidiary of Bard Productions Limited ("Bard"), a corporation formed by Scheer and Francoeur to produce the entire canon of 38 Shakespearean plays. Bard was the executive producer of Merry Wives. On December 31,

1980, the MW partnership acquired all rights to Merry Wives from Bard I. [App. 1208-10.]

Taxpayer Helba viewed Merry Wives prior to acquiring the videotape and requested an appraisal. Mr. Eliscu determined that the partnership should receive approximately $5,100,000 in distribution revenues over a five-year period from United States and foreign television, cable and closed circuit television and the sale of videocassettes and discs. [App. 1427(a) & (b), 1532, 1535.]

In 1981, the Shakespeare Video Society of America ("SVS") produced MacBeth for Bard, Inc. II ("Bard II") a wholly owned subsidiary of Bard. SVS is a subsidiary of a nonprofit corporation, Santa Barbara Gazebo Theater I ("Gazebo"). The MB partnership acquired all rights to the MacBeth videotape from Bard II on October 21, 1981. [App. 1326-44, 1645.]

C. The Economic Reasons Why the Purchase Transactions Were Structured as They Were

Because the estimated costs of production for the Videotapes were greater than taxpayer Helba believed that he could raise in cash through a private securities offering, the decision was made between taxpayer Helba, Century and Solaris to defer a portion of the costs of production. It was estimated that the cash cost of production of the two children's series would be approximately $725,000 each. [App. 1521, 1548.] Television programs were at that time being produced by the major networks for approximately $150,000 per one-half hour. [App. 1562,

1563, 1568.] Warren Baker, director of programming for all NBC-owned television stations in the United States, testified that if the Videotapes had been produced for all cash paid at the time of production, the cash costs would have been approximately $700,000. [App. 1637, 1640.] Taxpayer Helba believed that he could raise approximately $250,000 in cash for the production of each series. The deferred estimated costs of production were capitalized at a 20% rate over a seven year period, to which a 25% profit margin was added for JP V and JP II, and the total purchase price was determined, mathematically, to be $2,300,000. Solaris charged JP V and JP II $1,675,000 for the production of the Videotapes, payable $175,000 at the time of production, with the $1,500,000 balance plus 9% interest thereon due on, or before, February 1, 1987.

After a budget had been prepared by Bard and SSA, the selling price of Merry Wives was determined to be $2,320,000. Scheer believed that he could produce a Shakespearean play for roughly the same total cost as a children's series using slightly more cash initially. [App. 1621.] NBC's Warren Baker determined that the production of Merry Wives or MacBeth would have cost approximately $800,000 if all cash had been paid at the time of production. [App. 1504-06.] Respondent's witness, James Sowards, estimated that based on the quality of Merry Wives and MacBeth relative to the B.B.C. Shakespeare Productions, and the cost of the B.B.C. Productions, Merry Wives and MacBeth would have cost between $600,000 and $900,000 if all cash had been paid in the year of production. [App. 1646, 1647, 1645-1645(c).]

During the process of negotiations regarding the purchase of the Videotapes, taxpayer Helba insisted that the Partnerships get all ancillary rights, such as the rights to music and the original characters. Although JP V and JP II wanted to retain their rights, CFL and GMS were granted these rights. [App. 1525, 1614, 1615.] Taxpayer Helba also negotiated regarding the 9% interest rate on the promissory note, with taxpayer Helba requesting a lower 6% rate and Scheer requesting a rate in excess of 9%; ultimately, a 9% simple interest rate was agreed upon, with a minimum annual payment of $52,000. [App. 1522.] Taxpayer Helba also negotiated regarding the due date of the deferred balance of the purchase price. Scheer wanted the balance due in seven years from execution of the Acquisition Agreement and taxpayer Helba requested that the note be due the February following the seventh year after execution. [App. 1629.]

Solaris employed a common technique in the entertainment industry of giving creative people involved in the production "points," or percentages of amounts received by Solaris with respect to the production. For example, the stars of Memoirs and Geppetto's got a small amount of cash up front, with a larger additional amount due out of revenues Solaris received from JP V, JP II, CFL and GMS. [App. 1573.]

None of the various unions knew which union would have jurisdiction over a videotaping of a play on stage intended primarily for the videocassette market. None of the unions had any contracts governing this type of production, so SSA and Bard had to develop a method of compensating the participants themselves. Eventually, the American Federation of Radio and Television Artists

("AFTRA") approved of the concept of "points." The points system was a method of payment for services where the talent would be paid the lowest possible scale rate, nonbroadcast, and would be issued promissory notes. Under the promissory notes, the participant would receive a portion or "point" of 70% of the minimum annual interest payment payable by the Partnership and a portion of 70% of the deferred contract balance upon maturity of the obligation. The minimum annual interest payments and payment on the principal amount of the notes would be applied against residuals and against change in status of the production from nonbroadcast to broadcast status. Bard also granted the artists a security interest in Merry Wives or MacBeth's contract with Bard. [App. 1582, 1586-98, 1632.]

Bard and Thad Taylor believed that they could not get the caliber of people who worked on the production for the cash portion paid without promising them guaranteed deferred payments. The agents representing the talent would not allow them to participate without points. The concept of a point arose in part because agents expressed a need for a residual payment, common in motion pictures and television. Because the home video market was untested and unestablished, a system was developed which would be accepted by all the unions and guilds, as well as actors, directors and producers. Because the home video market was untested, the promissory notes were issued both to reduce initial cash costs, and to compensate talent for taking the risk in participating in a production aimed at a medium and market which was only beginning. Deferred compensation, sometimes called a "put", where talent is paid a sum

certain in the future, is commonly used in the entertainment industry to defer production costs until a time when, it is hoped, the production is generating income. The promissory notes issued by Bard are a form of a put. [App. 1582-89, 1590-92, 1597, 1634-35.]

SSA received a promissory note in the principal amount of $362,000 for providing the facilities for preproduction and production and for producing the Videotape. Thad Taylor and SSA were represented by independent counsel during the negotiations with Bard and are not related to Bard or any of its subsidiaries or taxpayer Helba. Thad Taylor and SSA expected to be paid on the promissory notes which they hold, and Taylor testified that he and SSA would sue to recover the full amount of the note from Bard, Century, taxpayer Helba or anyone else with a direct relation to the transaction. [App. 1599-1603.]

Negotiations with the talent regarding employment in the MacBeth production dealt heavily with deferred compensation in terms of points. Cohon and Gardner, attorneys for the production of MacBeth and Piper Laurie, one of the stars of MacBeth, through Rosejay, Inc., her personal service company, have executed and filed a UCC-1 to perfect their security interests in the MacBeth videotape. [App. 1350-69, 1583.] When Bard I or Bard II have been late making minimum annual interest payments to the talent, several artists have sued Bard, MW or MB to recover on the promissory notes. [App. 1260-1315, 1604.]

Each partner of the Partnerships has executed a Certificate of Limited Partnership ("Certificate") and an

Agreement of Limited Partnership ("Agreement"). The Certificate and the Agreement provided that each partner would make additional capital contributions for their proportionate share of the principal amount of the promissory note and for their pro rata share of the minimum annual interest payments. Each limited partner executed an Assumption Agreement wherein they agreed to contribute up to specified amounts per interest to the Partnership if any amount of principal or interest on the promissory note was due or payable on the maturity date. This liability was the primary obligation of each limited partner, and each partner had no right of indemnification, contribution, or subrogation against the Partnership, the general partner, or anyone else, except a right of contribution from other limited partners who had executed Assumption Agreements. JP V and JP II, Bard I and Bard II were given the right to proceed directly against each limited partner in the event that a limited partner failed to contribute his portion of the minimum annual interest payment or the contribution upon the maturity date of the promissory note. [App. 1126-29, 1181-85.]

Taxpayer Helba retained the well-known Chicago law firm, Katten, Muchin, Gittles, Pearl and Zahler ("Katten"), and the accounting firm of Laventhal and Horwath ("Laventhal") for business, tax and securities advice regarding the structure of the transaction. During negotiations, the possibility of having the obligation for the deferred purchase price convert from a recourse obligation to a nonrecourse obligation was discussed. Jacob Brandzel, a tax partner at Laventhal, explained that from the legislative history to the Tax Reform as of 1976

("the 1976 Act") relative to Code section 465, it appeared that an obligation could convert from recourse to nonrecourse upon the occurrence of some independent event of economic significance. [App. 1523, 1642.]

Taxpayer Helba believed that he could more easily raise capital if the obligation could convert to a nonrecourse obligation. [App. 1642.] In 1979 through the present time the home video market has been a new, untried and high risk industry due to quick growth and fluctuations in the market. Because the investors were being asked to finance the production of videotapes for this market, which was not anticipated to mature into a substantial revenue producing market for four or five years, taxpayer Helba believed that the investors were assuming a high degree of risk. [App. 1524, 1529.] After extensive discussion, it was determined that the deferred obligations would convert from recourse to nonrecourse if either of the following conditions were met:

> (a) If $1,035,000 of principal and interest had been paid on the Promissory Note out of revenues received by the Partnership from distribution of Videotapes, or
>
> (b) Alternatively, if after the fourth anniversary date of the Promissory Note ("Determination Date"):
>
> (i) A minimum of 4,000,000 videocassette and/or videodisc machines had been sold in the United States; and
>
> (ii) If subsequent to the Determination Date but prior to the maturity date of the Promissory Note, a minimum of $100,000 of distribution revenues from the exploitation of the Videotape on videocassettes and videodiscs had been received.

The first condition was based on the theory that if the distribution revenues reduced the principal and interest by $1,035,000 within the first four years, then the Videotapes would have proven their commercial viability such that personal liability of the partners would be unnecessary because the Videotapes would adequately secure the obligation [App. 1524] or that the Partnerships could obtain the balance of the funds due from a bank or third parties. [App. 1644.] The second set of conditions were developed on the theory that if the home video market had developed such that 4,000,000 videotape or disc machines had been sold in the United States, and the Videotapes generated $100,000 in net distribution revenues from videocassette or disc sales after the fourth year, but prior to the due date of the obligation, the home video market would be large enough to profitably market the Videotapes and the Videotapes would have demonstrated their commercial viability within that market such that personal liability of the partners would be unnecessary to secure the obligation. [App. 1523 (a)-1523 (b).]

D. In This Case, the Promissory Notes Were Recourse Obligations Which Had Economic Substance and Were Not Shams

No modifications with respect to the Acquisition Agreements or Assumption Agreements relating to GMS, CFL, MW or MB have been made between Century, Bard, JP II, JP V, Bard I, Bard II and GMS, CFL, MW, MB or any of the partners therein [App. 1538, 1588] except that all distribution proceeds (rather than 80%) are being applied

by Century to reduce any outstanding balance of minimum interest payments due. [App. 1619.]

At the time of trial in February and March, 1985, the Partnerships were current on their minimum interest payments except for the payments due on December 30, 1984. JP V, JP II, and Bard I and Bard II have not received all of the minimum interest payments due December, 1984. [App. 1641, 1620, 1537, 1627.] The promissory notes and the Acquisition Agreements executed by CFL, GMS, MW and MB provide that the repayment of the principal amount of the deferred purchase price [App. 1174, ¶ 5(b)(iv)(B)] is the personal obligation of the general and limited partners to the extent that distribution revenues have been insufficient to satisfy the obligation prior to the due date unless the note converts to nonrecourse. At the time of trial, none of the promissory notes had converted from recourse to nonrecourse. [App. 1628.] **Indeed, the Government's position was that the Videotapes would never generate sufficient income to convert the notes from recourse to nonrecourse.** [*See, e.g.*, App.820-21.] Furthermore, in executing the Promissory Notes and Acquisition Agreement, it was taxpayer Helba's intent to bind himself and the Partnerships on a recourse basis. [App. 1556-57.] Under California law which governed the transactions, the talent involved in the videotape productions are third party beneficiaries who may hold taxpayer Helba and the other partners liable for principal amounts of the recourse notes. When Bard has been late in making the annual payments, several artists have sued Bard and/or the Partnerships to recover on the promissory notes. [App. 1260-1315, 1604.]

Subsequent to the purchase of the Videotapes by the Partnerships, the Videotapes have been distributed by, among others, Lorimar-Telepictures, Encyclopedia Britannica Educational Corp., and the Entertainment Network. Although the Videotapes did not generate as much income as was expected during the early years, at time of trial the Partnerships had reasonable expectations to receive revenues sufficient to earn a profit due to the explosion of the home video market at the time of trial. [App. 1130-59, 1186-99, 1384-1400, 1245-59, 1579-81.]

E. The Tax Court's Decision

The Commissioner disallowed all of taxpayer Helba's distributive share of loss and investment tax credit for tax years 1978, 1980 and 1981 based on the allegation, *inter alia*, that taxpayer Helba had failed to establish that the transactions occurred in fact or in substance. The Tax Court held that "the purchase transactions here in issue were in substance shams lacking economic significance beyond the expected tax benefits," citing *Falsetti v. Commissioner*, 85 T.C. 332 (1985). The Tax Court's decision was primarily based on its erroneous conclusion that taxpayer Helba miscalculated the interest rate in determining the future value of the deferred production costs. Using a formula, the origins of which are still, after appeal, unknown, the Tax Court erroneously determined that, due to the fact that the promissory notes bore a 9% interest rate, the interest rate on the deferred production costs was effectively 52% and thus the Partnerships paid too much for the Videotapes. Thereafter, in its opinion, the Tax Court repeatedly determined that further analysis of other factors was unnecessary.

F. The Third Circuit Appeal

Taxpayer Helba appealed the Tax Court's decision to the United States Court of Appeals for the Third Circuit. On appeal, taxpayer Helba determined that the effective interest rate on the deferred production costs was 26% taking into account the 9% simple interest rate on the Notes. Before the Third Circuit, the Commissioner admitted that the Tax Court erred in determining that the effective interest rate on the deferred production costs was 52%, and alleged that the effective interest rate was 29%. In spite of this substantial error, the Third Circuit affirmed the Tax Court's decision in a two sentence Judgment Order " . . . essentially for the reasons set forth by Jude [sic] Nims' in his written opinions. . . ." Taxpayer Helba seeks certiorari from this judgment order of the Third Circuit.

REASONS FOR GRANTING THE WRIT

I

THE TAX COURT'S DECISION THAT THE PARTNERSHIPS' PURCHASES OF THE VIDEOTAPES LACK ECONOMIC SUBSTANCE AS AFFIRMED BY THE THIRD CIRCUIT GREATLY EXPANDS THE PARAMETERS OF THE ECONOMIC SUBSTANCE DOCTRINE BEYOND THOSE CONTEMPLATED BY THE DECISIONS OF THIS COURT

The economic substance doctrine, wherein the Tax Court determines that all deductions claimed by a taxpayer should be disallowed because he did not, for tax purposes, do what he purported to do, has become the

single most widely used method employed by the Tax Court to disallow deductions claimed by taxpayers. In this case, the Tax Court and the Third Circuit have greatly expanded the scope of the economic substance doctrine beyond the scope intended by this Court in *Knetsch v. United States*, 364 U.S. 362 (1960) and *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

In *Knetsch*, the taxpayer purchased deferred annuity savings bonds with $4,000 in cash and $4,000,000 in the form of a nonrecourse note. The taxpayer claimed yearly interest deductions on the nonrecourse note and paid the interest by borrowing the yearly increase in the value of the annuity contracts. This Court determined that the transactions were shams stating that "[p]lainly, therefore, Knetsch's transaction with the insurance company did 'not appreciably affect his beneficial interest except to reduce his tax.'" *Id.* at 366.

In *Frank Lyon Co. v. United States, supra*, this Court determined that the sale-leaseback of certain real estate was not a sham where " . . . there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties." 435 U.S. at 583-584. Prior to the time the present case was decided, the lower courts had largely confined the economic substance doctrine to the two areas in which this Court had found it applicable, namely, in sale-leaseback transactions, and in the context where the taxpayer purchased a position in securities financed

by another position or loan which, taken in context with each other, offset the economic risk of the position with respect to which deductions were claimed. *See, e.g., Rice's Toyota World v. Commissioner,* 752 F.2d 89 (4th Cir., 1985), *aff'g in part* and *rev'g in part* 81 T.C. 208 (1984); *Goldstein v. Commissioner,* 364 F.2d 734 (2nd Cir., 1966); *Bridges v. Commissioner,* 325 F.2d 184 (4th Cir., 1963); *Falsetti v. Commissioner,* 85 T.C. 332 (1985); and *Fox v. Commissioner,* 82 T.C. 1001 (1984). In all of these cases the transactions were structured such that there was no possibility of profit from the transaction.

After decision of the present case, the lower courts have used the economic substance doctrine in a wide variety of contexts. *See, e.g., James Rose v. Commissioner,* 88 T.C. 386 (1987), *Avers v. Commissioner,* 55 T.C.M. 678 (1988) and *McCain v. Commissioner,* T.C.M. 1987-285. The classes of transactions which are deemed to be shams or to lack economic substance have been substantially broadened from those where the taxpayer shuffles labels and documents, claiming deductions in instances where nothing of substance has been produced except tax deductions, and no economic risk assumed by the taxpayer except a risk of audit by respondent.

The Tax Court's decision that the instant transactions were shams has gone far beyond the traditional analysis of whether the transactions had *any* non-tax purpose or effect. In this case taxpayer Helba produced entertainment product which was admittedly different from standard television network fare with the intention of profiting from public dissatisfaction with limited choices provided by the networks once the home video market matured sufficiently to become a major market. This

motive was confirmed even by the witnesses called by the Government. The economic risk taken was commensurate with the deductions claimed because the sellers of the Videotapes and participants in the productions had recourse to the partners' assets. The Tax Court has penalized taxpayer Helba for producing the Videotapes in anticipation of a market at a time when the entertainment industry and the unions had not yet developed forms and contracts for that market.

The Tax Court's test as enunciated in this case is not whether the transactions had any business purpose other than tax avoidance motives, but rather whether "the purchases here in issue were in fact made with the intent of acquiring a profit generating property for which notes would be executed and enforced in accordance with their terms." Congress has provided specific statutory framework for such issues. The issue of whether the Partnerships acquired a "profit generating property" should rather be examined in the context of Internal Revenue Code section 183, *i.e.*, whether the Partnership entered into the transactions with the objective of producing a profit. The issue of whether the notes would be enforced according to their terms should have been examined in the context of whether the notes are valid indebtedness for the purposes of inclusion in the Partnerships' basis in the assets or the partners' basis in their Partnership interest. Instead the Tax Court has completely subsumed these specific issues in a general "economic substance" doctrine which is vague and without statutory parameters. Thus, it is important for this Court to hear this case in order to provide the lower courts with some guidance as to the parameters of the sham transaction doctrine which

has overwhelmed the analysis of transactions in relation to the statutory framework set forth by Congress.

This Court should grant certiorari in the instant case to decide whether the Tax Court has reasonably expanded the tests laid down by this Court in *Knetsch* and *Frank Lyon Co.* The instant case provides an ideal vehicle for such a determination because the business purposes of taxpayer Helba were undisputed at trial. Under the *Knetsch* test, this Court held that a transaction was a sham because "there was nothing of substance to be realized by Knetsch beyond a tax deduction." 364 U.S. at 366. In this case, the taxpayer acquired videotapes which he reasonably expected to generate a profit and is now penalized not only by market conditions to date but also by the I.R.S. Under *Frank Lyon Co.*, a transaction passes muster if there is a genuine multiple party transaction with economic substance which is compelled or encouraged by business realities. 435 U.S. at 583-584. Because there was economic substance dictated by business realities in the instant case, the Third Circuit and the Tax Court should have honored "the allocation of rights and duties effectuated by parties" in this case. 435 U.S. at 584.

This case is also important because it affects many other taxpayers and involves hundreds of millions of dollars in tax, penalties and interest. Not only does the case affect the tax liability of the other partners in the four Partnerships, but respondent is taking the position that it is determinative of the tax treatment of other partnerships which purchased children's, music and cultural videotapes from Century and Bard related producers.

II

THE THIRD CIRCUIT'S DECISION IN THIS CASE CONFLICTS WITH DECISIONS OF THIS COURT AND THE FOURTH CIRCUIT

The Third Circuit affirmed the Tax Court's decision in a two sentence Judgment Order and thereby incorporated the Tax Court's reasoning in its Order. The Tax Court determined that, notwithstanding the fact that the seller of the Videotapes and the participants in the productions might have full recourse against the partners and their assets, the transactions lacked any economic substance. This decision is in clear conflict with the Fourth Circuit's opinion in *Rice's Toyota World v. Commissioner, supra,* 752 F.2d 89 (4th Cir., 1985).

Rice's Toyota World v. Commissioner involved a sale and leaseback of a six-year-old computer. The taxpayer purchased the terminals for $250,000 in cash, payable in $62,500 yearly installments over a four-year period, and executed two nonrecourse notes in the amounts of $1,057,741 and $147,486. Rice leased the terminal back to the seller and the seller subleased the terminal to an end user. By the terms of Rice's lease to the seller, Rice would only realize $10,000 a year in income for a five-year period (due to the differential between Rice's payments on the nonrecourse loans and the rental paid by the seller) because the seller's lease payments were contingent upon the five-year sublease to the user. The lease payments by seller to Rice would have paid the nonrecourse loans in a ten-year period. The Tax Court found that because the residual value of an eleven-year old computer was so low, the terminal could not generate

sufficient revenue to pay the nonrecourse loans or return Rice's $250,000 cash payments after the expiration of the user's sublease.

The Fourth Circuit affirmed the Tax Court's decision in part, but reversed the Tax Court's decision insofar as it had determined that recourse note lacked economic substance. The Fourth Circuit stated:

> "But the 'cash payment' was merely the first installment due on the back-dated note. *The other installments were equally genuine obligations notwithstanding they were deferred, and the interest due upon their payment was equally an obligation of economic substance.* Rice could no more walk away without liability from the deferred principal and interest obligation than it could walk away from the obligation to pay the first installment.
>
> "For this reason, Rice's recourse note is fundamentally different from the nonrecourse notes held not to constitute genuine debt in cases such as *Hilton*, 74 T.C. at 364. Moreover, *Knetsch*, 364 U.S. at 362-65, does not suggest that the debt represented by the note was not genuine because Rice did not borrow his own money to create interest expense as, in effect, did the taxpayer in *Knetsch*. See also *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966); *Bridges*, 325 F.2d at 184.
>
> "Under *Frank Lyon*, the court may not ignore transactions that have economic substance even if the motive for the transaction is to avoid taxes. See 435 U.S. at 583-84." (*Id.* at 96.) (Emphasis added.)

Thus, the Third Circuit's and the Tax Court's decisions in this case, by ignoring the economic substance of the recourse notes executed by the Partnerships, directly conflict with the Fourth Circuit's holding in *Rice's Toyota World v. Commissioner*. This Court and no Court of

Appeals has, heretofore, determined that a recourse note was in substance a sham except in the narrow factual situation of *Goldstein v. Commissioner, supra,* and *Bridges v. Commissioner, supra,* where the taxpayer borrows his own money to create an interest deduction. In cases such as this, where there are literally hundreds of persons who could enforce payment of the Partnerships' notes, there are non-tax and real economic effects to the transactions. This Court should grant certiorari to the Third Circuit in this case to resolve the conflict between the circuits regarding whether an obligation lacks economic substance in an instance where the obligee or obligees have full recourse against the assets of the obligors.

CONCLUSION

For the foregoing reasons, petitioner James Helba, Jr., urges this Court to grant his petition for writ of certiorari to the United States Court of Appeals for the Third Circuit.

Dated: January 6, 1989.

Respectfully submitted,

HENRY W. WALTHER
JOHN D. HUMBERT
Deering, Walther & Sands
and
RUSSELL IUNGERICH and
RUSSELL IUNGERICH
A Professional Law Corporation

Attorneys for Petitioner
James Helba, Jr.

APPENDIX A

App. 2

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

Nos. 88-1061 and 88-1062

JAMES HELBA, JR.,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE

On Appeal from the United States Tax Court
(Tax Court Nos. 8218-83 and 21648-84)
Tax Court Judge: Arthur L. Nims, III

Argued: September 1, 1988

Before: SLOVITER, GREENBERG and COWEN,
Circuit Judges.

JUDGMENT ORDER

After consideration of all the contentions raised by appellant and essentially for the reasons set forth by Jude Nims in his written opinions filed October 30, 1986 and October 19, 1987 and reprinted at pages 108 and 236 in the appendix, it is

ADJUDGED and ORDERED that the judgment of the tax court be and is hereby affirmed.

Costs taxed against the appellant.

ATTEST: /s/ Sally Mrvos
Sally Mrvos, Clerk
Dated: SEP 9 1988

By the Court,
/s/ illegible
CIRCUIT JUDGE

APPENDIX B

T.C. Memo. 1987-529

UNITED STATES TAX COURT

JAMES HELBA, JR., Petitioner *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 8218-83, 21648-84. Filed October 19, 1987.

Petitioner objected to respondent's computations under Rule 155 on several grounds. *Held,* petitioner conceded the issue of guaranteed payments. *Held further,* respondent conceded that I.R.C. section 6621(c) is not applicable to the portion of the underpayments attributable to petitioner's failure to include the guaranteed payments in income. *Held further,* as noted in the Court's opinion at 87 T.C. 983 (1986), it was unnecessary to address the deductibility of miscellaneous expenses claimed by petitioner in light of the Court's finding that the transactions in the case were in substance shams lacking economic significance beyond expected tax benefits. Accordingly, decisions will be entered in accordance with respondent's revised computations.

Henry W. Walther and *John D. Humbert,* for the petitioner.

Phoebe L. Tang, for the respondent.

SUPPLEMENTAL MEMORANDUM OPINION

NIMS, *Judge:* On October 30, 1986, the Court filed its opinion in these cases, 87 T.C. 983 (1986), but withheld entry of its decisions to enable the parties to submit

computations in accordance with Rule 155.[1] Respondent filed his computations under Rule 155 on May 29, 1987. Petitioner objected to respondent's computations and filed alternative computations on July 9, 1987. On August 10, 1987, respondent filed responses and objections to petitioner's computations.

The parties' computations reflect disagreement concerning the following four issues: (1) whether guaranteed payments of $32,000 from Children's Fantasy, Ltd. (CFL) and $15,000 from Geppetto's Music Shop (GMS) should be included in petitioner's income for the taxable year 1979;[2] (2) whether a guaranteed payment of $26,275 from Merry Wives, Ltd. (MWL) should be included in petitioner's income for the taxable year 1980;[3] (3) whether section 6621(c)[4] is applicable to the portion of the underpayments attributable to petitioner's failure to include the guaranteed payments in the income of the proper year; and (4) whether petitioner is entitled to deduct miscellaneous expenses such as legal and accounting fees, organizational expenses and office expenses.

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[1] All Rule references are to the Tax Court Rules of Practice and Procedure. Unless otherwise indicated, all section references are to the Internal Revenue Code in effect during the years in issue.

[2] The case at docket No. 8213-83 involves the taxable year 1979.

[3] The case at docket No. 21648-84 involves the taxable years 1980 and 1981.

[4] Section 6621(d) was redesignated as section 6621(c) by section 1511(c)(1)(A) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2744.

In the notice of deficiency for the taxable year 1979, respondent determined that petitioner was required to include in his income the amount of $47,000 as guaranteed payments from CFL and GMS. In the notice of deficiency for the taxable year 1980, respondent determined that petitioner should include $26,275 as a guaranteed payment from MWL in his 1980 income. Petitioner filed a petition with respect to each notice of deficiency, and each petition alleged that respondent erroneously determined that the amounts are guaranteed payments includable in gross income.[5] Petitioner's trial memorandum, ordered filed as part of the record, did not include a

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[5] In the petition in the case at docket No. 8218-83, which involves the taxable year 1979, petitioner alleged that "The Commissioner erroneously determined that the petitioner must accrue $47,000.00 into income for the taxable year 1979 as that amount constituted unreceived guaranteed payments from Children's Fantasy, Ltd. and Geppetto's Music Shop." As a basis of his assignment of error, petitioner alleged that the management fee of $32,000 from CFL was not a guaranteed payment until 1980 and that the management fee of $15,000 from GMS was not guaranteed in 1979.

In the petition in the case at docket No. 21648-84, which involves the taxable years 1980 and 1981, petitioner alleged that "The Commissioner erred in determining for taxable year 1980 that petitioner was required to report $26,275.00 as guaranteed payments from Merry Wives, Ltd., on his income tax return." Petitioner alleged no factual or legal basis for his assignment of error with respect to respondent's determination that petitioner must include $26,275 as a guaranteed payment from MWL in his 1980 income.

discussion of the issue of guaranteed payments. Petitioner's brief included requested findings of fact with respect to the disputed payments received from CFL, GMS and MWL. However, petitioner's brief failed to include a discussion, legal or factual, of the issue of the guaranteed payments. Based on the above facts, we concluded that petitioner had conceded the issue of guaranteed payments. See *Calcutt v. Commissioner*, 84 T.C. 716 (1985). Therefore, we sustained respondent's determinations in the notices of deficiency that petitioner was required to include guaranteed payments of $32,000 from CFL and $15,000 from GMS in his 1979 income and $26,275 from MWL in his 1980 income. Accordingly, we find that respondent's Rule 155 computations are not erroneous on this point.

In connection with his computations under Rule 155, petitioner alternatively argues that if the guaranteed payments are included in his income as determined by respondent, then such payments should be excluded from his income in the years in which he included the payments. Thus, petitioner's Rule 155 computations raise the issue of double inclusion of income. However, neither petitioner's petitions,[6] trial memorandum nor brief raised the issue of double inclusion of income.

Rule 155 is the mechanism through which the Court enters a decision for the amount of deficiency or overpayment resulting from the disposition of the issues involved in a case. *Harwood v. Commissioner*, 83 T.C. 692, 694 (1984), affd. without published opinion 786 F.2d 1174 (9th Cir. 1986); *Cloes v. Commissioner*, 79 T.C. 933, 935 (1982). Petitioner failed to raise the issue of double inclusion of

[6] Rule 31(c) permits pleading in the alternative.

income prior to the submission of computations under Rule 155. See *Koufman v. Commissioner,* T.C. Memo. 1977-225. Rule 155(c) provides that new issues will not be considered. *Cloes v. Commissioner,* 79 T.C. at 935. Consequently, we will not consider petitioner's issue of double inclusion of income in the context of Rule 155 computations.

In his Rule 155 computations, petitioner argues that respondent erroneously applied section 6621(c) to the portion of the underpayments attributable to petitioner's failure to include the guaranteed payments in the income of the proper year.[7] In his responses to petitioner's computations, respondent concedes that section 6621(c) is not applicable to the portion of the underpayments attributable to the omission of the guaranteed payments. Respondent, therefore, revised his computations under Rule 155.

Petitioner argues that the Court did not address the issue of whether petitioner is entitled to deduct miscellaneous expenses such as legal and accounting fees, organizational expenses and office expenses. In its opinion, the Court initially noted that one of the issues for decision was whether petitioner was entitled to deduct certain miscellaneous expenses. 87 T.C. at 984. After finding that the transactions in the instant case were in substance shams lacking economic significance beyond expected tax benefits, the Court held that it was unnecessary to address the remaining issues. 87 T.C. at 1014. The

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[7] The Court limited its consideration of the applicability of section 6621(c) (formerly designated as section 6621(d)) to the portion of the underpayments attributable to the partnerships' basis overstatements. *Helba v. Commissioner,* 87 T.C. 983, 1014 n.17 (1986).

"remaining issues" includes the issue of whether petitioner was entitled to deduct miscellaneous expenses.

Decisions will be entered in accordance with respondent's revised computations.

APPENDIX C

87 T. C. No. 63

UNITED STATES TAX COURT

JAMES HELBA, JR., Petitioner *v.*
COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket Nos. 8218-83, 21648-84. Filed October 30, 1986.

Petitioner was the general partner in four partnerships which purchased videotaped productions. Each of the partnerships paid approximately $2,300,000 for a production. In each case, more than $2,000,000 of the purchase price was paid with a note guaranteed on a pro rata basis by the limited partners. The notes were initially fully recourse, but could convert to nonrecourse on the occurrence of certain contingencies. Each of the videotapes was purchased from a corporation which was either directly or indirectly controlled by Lawrence Scheer. Scheer effectively controlled all aspects of the transactions, while petitioner's primary activity involved obtaining investors for the partnerships. *Held,* the purchase transactions here in issue were in substance shams lacking economic significance beyond expected tax benefits. *Falsetti v. Commissioner,* 85 T.C. 332 (1985).

Held further, petitioner is liable for additional interest pursuant to section 6621(d) with respect to the amount of the underpayments attributable to basis claimed in the property in issue because such underpayments are attributable to tax motivated transactions. Sections 6621(d)(3)(A)(1), 6659(c), I.R.C. 1954.

Kenneth M. Barish, Henry W. Walther, and *John D. Humbert* for the petitioner.

Marshall W. Taylor and *Phoebe L. Tang,* for the respondent.

NIMS, *Judge:* Respondent determined the following deficiencies in petitioner's Federal income taxes:

Year	*Deficiency*
1979	$40,701.00
1980	54,942.12
1981	35,482.90

The issues for decision are:

1. Whether the transactions between the partnerships, executive producers and producers were tax shams lacking economic substance;

2. Whether the activities of the partnerships with respect to the purchase and distribution of the videotapes constitute activities engaged in for profit within the meaning of section 183;[1]

3. Whether the partnerships may include in their basis in the videotapes the amounts represented by convertible notes;

4. Whether petitioner's basis in his partnership interests includes amounts attributable to services rendered or amounts paid with a promissory note;

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 in effect during the years in issue. All rule references are to the Tax Court Rules of Practice and Procedure.

5. Whether petitioner's amount at risk includes his pro rata portion of the partnerships' liabilities represented by the convertible notes;

6. Whether the partnerships used a proper method of depreciation for the videotapes;

7. Whether the partnerships are entitled to deduct organizational costs, management fees, legal fees, commissions and interest in the years in which they were incurred or paid;

8. Whether petitioner is entitled to claim investment tax credits with respect to the videotapes; and

9. Whether petitioner substantially underpaid tax in the years in issue as a result of a tax motivated transaction within the meaning of section 6621(d).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Background

Petitioner resided in Pittsburgh, Pennsylvania, at the time the petitions were filed in this case.

Petitioner is a certified financial planner and was a general partner in each of the four limited partnerships which are the subject matter of this case. The four partnerships are Children's Fantasy, Limited (CFL), Geppetto's Music Shop (GMS), Merry Wives, Limited (MWL)

and Macbeth, Limited (MBL) (collectively referred to as the "partnerships.")

Petitioner also held an interest as a limited partner in MWL. Each of the partnerships elected to use the accrual method of accounting.

As a certified financial planner, petitioner evaluated investment alternatives and advised clients on choosing investments. In the Fall of 1978, petitioner attended a four-day convention of the International Association of Financial Planners where, among other investment opportunities, firms were marketing videotape programs. Prior to this, petitioner had no knowledge or background in videotapes, movies, films, the home entertainment industry, or product distribution, other than being involved with the distribution of one film in 1976. Petitioner contacted only a few sellers of videotape investments, but he did receive a great deal of literature on such investments.

Knowing of petitioner's interest in videotape products, a colleague of petitioner's suggested that he contact Century Video Corporation (Century). Petitioner contacted Lawrence Scheer at Century in November, 1978. Scheer had formed Century in 1977, to act as an executive producer of television products. Scheer had first begun researching television production and the home video market in 1976. Prior to this, he had a 25-year career in the life insurance business. Leonard Francouer was the president and a director of Century.

Between 1977 and 1980, Century marketed single shows to individuals by use of an investment vehicle referred to as "one-on-ones." Century contracted with

Solaris International Pictures, Inc. (Solaris) to produce these shows. Century generally sold the one-on-ones to individual investors for a fixed price of $100,000, usually consisting of $10,000 cash and a promissory note in the amount of $90,000. Century would pay Solaris $6,000 to $7,000 in cash and execute a promissory note for $60,000 to $65,000 for the production. The notes executed by the investors were initially fully recourse with respect to the investors, but upon the occurrence of certain contingencies could convert to nonrecourse.

Solaris was a company through which Glenn Taylor produced television programs.[2] Through at least 1979, Glenn Taylor did not own any of Solaris' stock, but at some undetermined date he acquired an option on Solaris' stock by guaranteeing approximately $1,000,000 of the company's debt. He later gained control of Solaris by exercising this option. Glenn Taylor had previously produced television programs through a wholly-owned company, Snytar Productions (Syntar), but when Solaris was formed it took over the use of Syntar's production facilities. From 1975 to 1977, Syntar's productions were predominantly one-half hour shows which were financed by use of one-on-one investments. During 1976 and 1977, approximately 100 to 110 individuals purchased videotape productions from Syntar.

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[2] The role of a production company such as Solaris or Syntar is to create the production. This includes writing the production and providing a producer, creative staff, and talent.

Prior to 1979, Century sold approximately 120 Solaris one-on-ones to 80 individuals. Starting in early 1979, petitioner recommended the purchase of videotapes marketed by Century to his financial planning clients. Approximately 20 of petitioner's clients invested in the one-on-ones, for which petitioner received client fees and sales commissions. None of these one-on-ones have returned any income to their individual investors.

Production and Financing Structure

In 1977, Scheer met with Jacob Brandzel, a tax partner in the accounting firm of Laventhol and Horwath, and Shelley Banoff, a tax attorney in the Chicago law firm of Katten, Muchin, Gitles, Zavis, Pearl & Galler, to discuss changes in the tax laws and development of a financing structure for producing videotapes based on a partnership format. The financing structure developed by Scheer, Brandzel and Banoff was used as the basis for the partnerships in this case. The plan required the partnerships to enter into a contract to purchase a videotaped production from an executive producer in exchange for cash and a note. Investor/limited partners contributed cash to the partnership and executed assumption agreements which made them personally liable for a pro rata portion of the note executed by the partnership. The liability of the limited partners pursuant to the assumption agreements, however, could terminate upon the occurrence of certain contingencies.

The executive producer was to acquire the videotaped production by entering into a production order subcontract with a producer. This contract would allow

the executive producer to pay for the production by use of cash and deferred obligations. The producer, in turn, would hire talent to work on the production by paying them minimum cash payments and deferred obligations.

Debt Structure

Banoff and Brandzel also developed the form of the notes executed by the partnerships and the assumption agreements executed by the investor/limited partners. The outstanding principal on each note, along with the accrued but unpaid interest, was due on February 1 of the eighth year following the year in which they were executed. The notes bore interest at an annual rate of nine percent, but interest in excess of $52,000 per year could be accrued and added to principal. The partnerships were required to use 80 percent of the gross receipts from distribution to pay principal and interest on the notes in each year.

The liability of the investor/limited partners under the assumption agreements could terminate, and the notes become nonrecourse, upon the occurrence of either of two contingencies. Their liability terminated if, at anytime during the term of the note, the partnership made payments on the note (interest and/or principal) totalling at least one-half of the principal amount of the note. If such payments were not made within 4 years following the execution of the note, however, the seller acquired exclusive rights to distribute video cassettes and video discs of the production. Thereafter, the liability of the limited partners would terminate if 4,000,000 (5,000,000 in the case of MBL) video disc and video cassette players had been sold in the United States, and $100,000 of gross

distribution revenues were received after the end of the fourth year but before the maturity date of the note.

The principal amount of the note was determined by using the following method: (1) the approximate cash cost of the production was determined; (2) the amount to be deferred was calculated by subtracting the amount of the cash down payment from the estimated cash cost of the production; (3) the amount to be deferred was "capitalized" at an annual interest rate of 20 percent over the term of the note[3]; and (4) this "capitalized" amount was increased by approximately 25 percent, so as to provide the seller with a profit. The note's nine percent stated interest accrued on the principal amount of the note calculated by this method. For each of the productions here under consideration, petitioner believed that the cash cost of production would be approximately $725,000.

Offering Memoranda

The offering memorandum for each of the partnerships contained a section entitled "Suitability Standards for Investors," which required a potential investor to represent that he had a net worth of at least $150,000 (excluding home, home furnishings and automobiles) or

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[3] Under the plan used by petitioner, this "capitalization" was done by determining the future value in 7 years of the amount to be deferred using a 20 percent annually compounded interest rate. This is done by multiplying the deferred amount by 1.20^7 or approximately 3.58. See Compound Interest and Annuity Tables, p. 1840 (C. Gushee 6th ed. 1980).

that he expected to have income during the year of investment and the succeeding year, which is taxable in a Federal tax bracket in excess of 50 percent, or if a corporate investor, taxable at the maximum regular corporate rate. The reasons given for this requirement were that the partnership interests were relatively illiquid and "that the relative financial benefit of an investment in the Partnership will generally depend substantially on the tax bracket of the investor."

The cost of a limited partnership unit, the number of units offered, the minimum number of units which could be purchased and the total anticipated capitalization for each of the partnerships, as set out in the offering memoranda, were as follows:

	CFL	GMS	MWL	MBL
Cost of one unit	$ 1,000	$ 1,600	$ 1,150	$ 1,200
Total number of units offered	350	250	350	350
Minimum units per investor	10	10	10	10
Total anticipated capitalization	$350,000	$400,000	$402,500	$420,000

The estimated use of these proceeds was shown to be as follows:

	CFL	GMS	MWL	MBL
Cash downpayment for production	$230,000	$230,000	$250,000	$270,000
First year interest payment[4]	30,000	30,000	30,000	40,000
General partner's fee[5]	32,000	30,000	26,275	40,000
Legal and accounting costs[6]	21,000	25,000	35,000	30,000
Partnership working capital	–	–	–	15,000
Reserve[7]	37,000	25,000	25,000	25,000
Sales commissions	–	30,000	36,225	–
TOTAL	$350,000	$370,000	$402,500	$420,000
Proceeds unaccounted for	–	30,000	–	–

[4] This was variously designated as "interest prepayment," "interest prepayment and reduction of principal" or "interest payment on the purchase price note."

[5] This was designated as either "general partner's initial management fee" or "general partner's fee for services in organizing the partnership."

[6] The MWL offering memorandum listed this as "legal and accounting costs incurred in connection with the offering and organization of the partnership."

[7] The reserve was designated as either "reserve for operations, extraordinary expenses and annual interest requirement," "reserve for accounting and legal fees in the event of an audit by the Internal Revenue Service," "reserve for operations, extraordinary expenses, annual interest requirement, working capital and other liabilities of the partnership" or "internal revenue service reserve."

The memoranda also informed the potential investor that a limited partner could be subject to an annual assessment if necessary to allow the partnership to meet its annual minimum interest payments.

The per unit cost of a partnership interest was not identified as including any portion of the liabilities to be assumed by the limited partners. The requirement that the limited partners execute the assumption agreements was explained in a section of the offering memoranda entitled "'At Risk' Provisions." This section explained that, due to the Tax Reform Act of 1976 and the Revenue Act of 1978, the investors would be limited in recognizing losses from the partnership to the extent their investment was "at risk." A partner's amount "at risk" was defined as "the amount of his actual net cash investment in the Partnership, plus the portion of any Partnership liabilities for which such limited partner is personally liable." Immediately following this explanation, it was stated that each investor would be required to accept personal liability for a pro rata portion of the principal amount of the purchase price note. This section also explained that the requirement of personal liability materially increased the risks to investors and that no party involved with the investment or production guaranteed that sufficient revenues would be generated to cause the purchase price note to become nonrecourse.

The offering memoranda stated the purchase price which would be paid by each of the partnerships and that

each of these purchase prices was based on "a represented projected production cost."[8] The purchase prices and the represented projected production costs for each of the productions to be acquired were shown to be as follows:

Partnership	Purchase Price	Production Cost
CFL	$2,300,000	$1,650,000
GMS	$2,300,000	$1,800,000
MWL	$2,320,000	$1,624,000
MBL	$2,300,000	$1,700,000

In none of the memoranda was it represented that the purchase price was the fair market value of the production or that the represented projected production cost was a reasonable production cost.

The section of the operating memoranda entitled "Anticipated Results of Operations," stated that while the ultimate goal of the partnership was to profit from the exploitation of the production, it was anticipated that during at least the first two years of operation losses would be incurred by the partnership. Schedules contained in the CFL and GMS offering memoranda showed anticipated expenses for the two partnerships during the years in issue, their first 3 years of operation, to be as follows:[9]

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[8] From the context in which it is used, this appears to mean represented by either the executive producer or producer.

[9] These schedules also showed anticipated investment tax credits of $153,000 in 1979 for each of the partnerships.

	CFL			GMS		
	1979	1980	1981	1979	1980	1981
Depreciation	$214,285	$582,994	$420,506	$ 80,357	$620,409	$447,231
Legal and accounting	10,000	1,500	1,500	15,000	1,500	1,500
Organizational fees	1,300	2,600	2,600	1,000	8,000	8,000
G/P management fee	32,000	1,200	1,200	–	3,000	3,000
Interest expense[10]	62,100	174,842/ 186,300	129,546/ 186,300	29,510	208,102/ 211,243	164,907/ 187,294
TOTAL EXPENSES	$319,685	$763,136/ 644,594	$555,352/ 612,106	$125,867	$841,011/ 844,152	$624,638 647,025

[10] The variation in interest expenses for the years 1980 and 1981 is a product of hypothetical assumptions about the amount of principal paid down in those years. The offering memoranda did not give these figures as projections of the amounts of principal which would be paid down in the years in issue.

No such breakdown of anticipated expenses was given in the MWL or MBL offering memorandum. None of the memoranda made projections of, or representations concerning, the income stream that could be expected from the exploitation of the productions.

Petitioner was the sole general partner of CFL and MBL, but was a co-general partner with Henry L. Chiesa in GMS and MWL. The offering memoranda identified petitioner as a certified financial planner, who acts as an insurance broker and general agent. Chiesa was identified as the president, chief executive officer and principal stockholder of Managed Investments, Inc., a broker/dealer.

The risk factors listed in the memoranda included the lack of experience of the general partner(s) in acting as a general partner of a limited partnership and lack of experience in the production, distribution, and exploitation of the type of productions involved. The memoranda also stated that the general partner(s) would rely substantially on the efforts of the sellers, executive producers, producers and distributors, and that while the general partner(s) would have sole control of the management of the partnership, he (they) would not be required to devote full-time efforts to the affairs of the partnership. The CFL and GMS memoranda also noted that the producer of the series had been in business for only a short time (1-1/2 to 2 years), that the distributor was a newly formed subsidiary of the producer, and that neither the producer nor the distributor had previous experience distributing television series. The MBL and MWL memoranda stated that

the producer had no other experience in producing videotapes of Shakespeare's plays and that there was insufficient prior experience concerning the distribution of theatrical videotapes for reliable estimates to be made of likely distribution revenues.

The general partner(s) received a one percent share of the profits, losses and distributable cash flow of the partnership in exchange for a cash investment of $1,000. As compensation for action as general partner(s), the offering memoranda stated that petitioner (and Chiesa in GMS and MWL[11]) would receive: (1) an initial fee, from the proceeds of the offering, for services rendered in organizing and managing the partnership; (2) an annual management fee commencing in the second year of partnership operations, which would be paid from net cash flow of the partnership after the minimum interest payments had been made in each year; and, (3) if the limited partners received cash distributions equal to 125 percent (100 percent in the case of CFL) of their cash investment and were no longer personally liable on the purchase price note, an increased percentage of distributable cash flow. The amounts of the initial fees, annual fees, and increased percentage of distributable cash flow were as follows:

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[11] The offering memoranda for GMS and MWL did not state the amounts of fees due the general partners separately, but only gave aggregate amounts.

	CFL	GMS	MWL	MBL
Initial fee	$32,000	$30,000	$26,275	$40,000
Annual fee	1,200	3,000	3,000	3,000
Increased percentage	11%	34%	34%	34%

The CFL and GMS offering memoranda stated that of the amounts paid to the seller of the production to reduce the purchase price note, 20 percent would be paid to Century as compensation for its services as executive producer, 75 percent would be paid to Solaris and 5 percent would be retained by the seller. The MWL memorandum stated that of the amounts paid to the seller, 70 percent would be paid to the producer. The executive producer was to receive no compensation for acting as executive producer of Merry Wives, other than the indirect benefits of the amounts retained by the seller, its wholly-owned subsidiary. The MBL offering memorandum did not designate the portions of the amounts paid to the seller which were to be passed on to the producer and executive producer.

Productions

In 1979, CFL and GMS financed the production of two 13 episode children's series entitled "Memoirs of a Fairy Godmother" (Memoirs) and "Geppetto's Music Shop" (Geppetto's), respectively. CFL acquired all rights to Memoirs from Justin-Pacific Corporation V (JPV), a wholly-owned subsidiary of Century. GMS acquired all rights to Geppetto's from Justin-Pacific Corporation II

(JPII), another wholly-owned subsidiary of Century. Century was the executive producer for each of these productions and created the Justin-Pacific subsidiaries for the sole purpose of financing their respective productions. Both Memoirs and Geppetto's were produced by Solaris.

In 1980, MWL purchased all rights to a master videotape of Shakespeare's play "The Merry Wives of Windsor" (Merry Wives) from Bard I, Inc. (Bard I), a wholly-owned subsidiary of Bard Productions, Ltd. (Bard). Bard was the executive producer of Merry Wives and was formed by Scheer and Francoeur to produce Shakespeare's canon of plays on videotape. Merry Wives was produced by and taped at the facilities of The Shakespeare Society of America (SSA). SSA was a nonprofit corporation which produced live Shakespeare plays, but which had no prior experience in the production of videotaped plays.

Merry Wives was originally planned for production in 1979, with funding to come from Windsor Partners, a partnership in which petitioner would have again been the general partner. The videotaping of Merry Wives was completed in 1979, but the partnership was not fully subscribed by the end of that year. As a result, Windsor Partners was abandoned in December, 1979, and the investors who had subscribed to interests in Windsor Partners had their contributions transferred to, and became limited partners in, GMS. MWL was then formed in 1980 to acquire Merry Wives from Bard I.

In 1981, MBL financed the production of a videotaped version of Shakespeare's play "Macbeth." MBL acquired all rights to the production from Bard II, Inc.

(Bard II),[12] a wholly-owned subsidiary of Bard. Bard was the executive producer of Macbeth and The Shakespeare Video Society (SVS), a nonprofit corporation, was the producer.[13] SVS was formed to produce Shakespearean plays for Bard because of severe production problems encountered in SSA's production of Merry Wives.[14] The principals of SVS, however, were independent of Bard.

The parties involved with the productions, the amounts paid by the partnerships to purchase their respective productions and the terms of the notes executed by the partnerships were as follows:

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[12] JPII, JPV, Bard I and Bard II each had an initial capitalization of $1,000 and no additional capital was ever added.

[13] The MBL offering memorandum states that SSA was to be the producer of Macbeth, but SVS was substituted for SSA.

[14] The production problems encountered with Merry Wives appear to have resulted from the fact that SSA's theater was not adequately designed for the videotaping of a play.

	CFL	GMS	MWL	MBL
Seller	JPV	JPII	Bard I	Bard II
Executive Producer	Century	Century	Bard	Bard
Producer	Solaris	Solaris	SSA	SVS
Execution Date of Acquistion Agreement	10/4/79	10/4/79	12/31/80	10/21/81
Total Purchase Price	2,300,000	2,300,000	2,320,000	2,300,000
Cash Down	230,000	230,000	250,000	270,000
Principal Amount of Note	2,070,000	2,070,000	2,070,000	2,030,000
Execution Date of Note	10/4/79	11/18/79	12/31/80	10/21/81
Maturity Date of Note	2/1/87	2/1/87	2/1/88	2/1/89
Payments required to trigger conversion in 1st four years	1,035,000	1,035,000	1,035,000	1,015,000

By 1978, Glenn Taylor had established an ongoing business relationship with Scheer and Century. In 1979, Solaris was Century's only producer, and Scheer neither negotiated with other producers nor cost-shopped with respect to the productions. At the time discussions began between Scheer and Solaris with respect to the production of Memoirs and Geppetto's, Solaris had produced over 100 children's shows for Century.

At the time petitioner became a general partner in each of the four partnerships, Scheer had already set the terms upon which the videotapes would be produced. As a result, there were no negotiations between petitioner and Scheer with respect to the prices to be paid by the partnerships for the videotapes. Petitioner did not request that Scheer obtain other bids for the production of Memoirs or Geppetto's. Nor did the petitioner inquire into the actual costs of Solaris in producing Memoirs and Geppetto's.

In 1979, both Century and Solaris made estimates of the production costs of Memoirs and Geppetto's. These estimates were based on the concept of executing notes with principal amounts in excess of the cash costs for certain of the expenses. John Filatreau, Solaris' accountant, developed the Solaris estimates by taking the production order subcontract price and backing out allocations by use of "accountant's license." No amount was allocated to Solaris' profit margin. Following the production of Memoirs and Geppetto's, Filatreau prepared a schedule of Solaris' production costs and profit markup by allocating expenses from the company financial records. The partnership returns for CFL and GMS also lists costs for the productions, but the costs are not

broken down and they include Century profit margins (which were not included in any of the other cost statements). These cost statements are summarized as follows:

For Memoirs –

	Solaris Estimate	Century Estimate[15]	Solaris Cost Schedule	Partnership Return
Story	263,300	232,700	403,750	–
Supervisors	277,700	101,400	170,000	–
Cast	200,000	131,300	77,625	–
Direction	100,000	104,000	170,000	–
Total Above the Line Cost	941,000	569,400	821,375[16]	–
Total Below the Line Cost	861,500	730,600	289,685	–
Total Cost of Shows	1,702,500	1,300,000	1,111,060	2,050,000
Record Albums, Cassettes and Storybooks	–	650,000	–	150,000
Ancillary Rights	–	–	–	100,000
Markup	–	–	591,440	–
Dated	10/30/79	1/7/79	–	3/18/81

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[15] The Century estimates were actually prepared on a per episode basis. Scheer testified that the proper estimates for the cost of each series could be obtained by multiplying the figures by 13, the number of episodes in each series. For comparison purposes, we have done so.

[16] For both Memoirs and Geppetto's, Solaris' post-production cost schedules designate the above the line costs as deferred costs.

For Geppetto's –

	Solaris Estimate	Century Estimate	Solaris Cost Schedule	Partnership Return
Story	263,300	299,000	403,750	–
Supervisors	277,700	104,000	170,000	–
Cast	200,000	187,200	77,625	–
Direction	100,000	104,000	170,000	–
Total Above the Line Cost	841,000	694,200	821,375	–
Total Below the Line Cost	861,500	930,800	289,685	–
Total Cost of Shows	1,702,500	1,625,000	1,111,060	2,300,000
Record Albums and Cassettes	–	260,000	–	–
Storybooks	–	65,000	–	–
Markup	–	–	591,440	–
Dated	12/21/79	11/1/79	–	3/13/80

The Century cost estimates were purportedly provided to petitioner prior to his entering into the acquisition agreements. As to Geppetto's, however, the acquisition agreement was executed prior to the date shown on the Century cost estimate. The dates shown on the Century cost estimates for each of the productions and the execution dates for each of the acquisition agreements also precede the dates shown on the Solaris cost estimates.

The amounts designated as the costs of the "story" in each of the cost breakdowns were amounts to be paid by Solaris to Syntar, Glenn Taylor's wholly-owned company, pursuant to licensing agreements. These agreements gave Solaris the right to use the story lines as developed by Syntar in exchange for $425,000 per production. For each of the productions, $21,250 was to be paid upon execution of the contract and the balance of $403,750 was to be paid out of 30 percent of all monies received by Solaris after Solaris had received $300,000. As to both productions, the licensing agreements were dated earlier than the Solaris cost estimates, but the Solaris cost estimates do not accurately reflect the agreed costs of the story lines. The amounts reflected on the Solaris cost schedules reflect the deferred portions of the agreed costs.

Solaris also executed administrative consulting contracts with Syntar for Memoirs and Geppetto's. Each of the contracts required Solaris to pay to Syntar, in exchange for Syntar's consulting services, 14 percent of all monies received by Solaris from the production after Solaris had received $486,500. It is unclear whether any of the cost estimates for Memoirs or Geppetto's reflect amounts to be paid by Solaris pursuant to these contracts,

but if Solaris were paid the full $1,702,500 due it, the payments required to be made to Syntar pursuant to the consulting contracts would be approximately $170,000, the amount shown in the Solaris cost schedule for "Supervisors."[17]

While the Century cost estimate for Memoirs shows a total estimated cost for record albums, cassettes and storybooks of $650,000, the CFL partnership return shows a cost basis in those items totalling only $150,000. The Century cost estimate for Geppetto's shows a total estimated cost for these items of $325,000, but the GMS partnership return does not claim any cost basis in such items.

Century also made estimates of the production costs of Merry Wives and Macbeth based on the concept of executing notes with principal amounts in excess of the cash costs for certain of the expenses. These cost estimates are summarized as follows:

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[17] This is calculated as follows:

(1,702,500 - 486,500) x 0.14 = $170,240

	Merry Wives	Macbeth[18]
Story	$ 500	$ 500
Supervisors	406,350	436,350
Cast	420,350	420,350
Direction	130,900	150,900
Total Above the Line Cost	958,100	1,008,100
Total Below the Line Cost	482,850	522,850
Total Direct Cost	1,440,950	1,530,950
Contingency	57,750	57,750
General Studio Overhead	111,300	111,300
Total Cost	$1,610,000	$1,700,000

The production order subcontract executed between Bard I and SSA obligated Bard I to pay $1,624,000 to SSA in consideration for the production. Of this amount, $175,000 was to be paid upon execution of the contract, and the balance, together with interest at the rate of nine percent per annum, was due on or before February 1, 1988. The contract also required Bard I to make interest and principal payments from 70 percent of any payments received from MWL.

While a production order subcontract was the focus of negotiations between Bard II and SVS, such a contract was not, in fact, ever executed. The understanding developed between Bard II and SVS was that Bard II would provide a certain amount of cash for the production of the play and that 70 percent of the amount received by Bard II from MBL would be paid to SVS. SVS was not involved in setting the $2,300,000 price which was to be paid by MBL, nor did SVS attempt to bargain for an

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[18] The cost estimate for Macbeth is dated July, 1980. This is prior to the formation of SVS, the producer of Macbeth.

interest in MBL's note in excess of the 70 percent it was offered by Bard II. The original cash budget agreed to was $225,000, but this was later increased to $245,000.

The 70 percent interest of SVS in MBL's obligation to Bard II was actually obligated to members of the production staff, cast and crew of Macbeth as compensation for their services. This was done by the manager of SVS, Susan Marrone, negotiating percentage interests with these individuals, and Bard II (not SVS) executing 7-year notes for the negotiated percentages. These notes bore interest at nine percent and were to be paid out of their stated percentages of amounts received by Bard II from SVS.[19] Two sets of notes, however, were actually executed by Bard II for this purpose. The original set of notes provided that if the principal had not been paid in full as of the maturity date, no further payments of principal or interest were to be made unless Bard II regained possession of the videotape and thereafter commercially exploited the videotape. The second set of notes, which replaced the original set, provided that if the principal and interest had not been paid in full as of the maturity date, all such amounts were then payable in full from Bard II.

Independent of the production order subcontract which had been executed by Bard II and SSA, the actual production arrangements for Merry Wives were similar to those for Macbeth. Bard I executed notes in favor of

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[19] This scheme guaranteed that those holding the notes would at least receive a percentage of the minimum interest paid by the partnership.

members of the production staff, cast and crew representing 70 percent of MWL's obligation to Bard I. This left Bard I obligated to SSA for only the cash amount agreed to in the production order subcontract. The notes executed by Bard I were similar to the second set of notes executed by Bard II for Macbeth and were not executed until early 1982. This was after the second set of notes were executed by Bard II and more than two years after the videotaping of Merry Wives.

Both SSA and SVS were required to enter into agreements with the American Federation of Television and Radio Artists (AFTRA) prior to the production of Merry Wives and Macbeth. Both of these agreements were non-broadcast production agreements. The agreement entered into by SSA allowed for broadcast uses of the production (i.e., use by network television, syndicated television, public television and pay television) only if SSA paid to the AFTRA members additional compensation as set forth in the AFTRA code. The agreement entered into by SVS, however, provided that SVS was required to notify AFTRA at least 60 days prior to the date of any broadcast use of the production and that SVS would then be required to bargain with AFTRA for the amount and terms of additional compensation to be paid the AFTRA members. The agreement also provided that the production was not to be released for broadcast use pending an agreement between SVS and AFTRA as to such additional compensation.

In 1980, CFL made loans to Century in at least the amount of $28,400. The loans were payable on demand and earned interest "at the prevailing rate of 'Fidelity cash reserve money market fund'." By the beginning of

1983, the total loan balance owed CFL by Century was $40,588.32. This amount was used as an offset in 1983 to unpaid 1982 minimum interest and 1983 minimum interest owed JPV by CFL.

In 1981, a receivable was created in favor of GMS in the amount of $24,912 with the same interest provisions as those applying to the loans from CFL to Century. This receivable resulted from overpayments to JPII and Century by GMS and Windsor Partners. As of the end of 1982, the balance owing on the receivable was $32,634.58. This amount was then used as an offset to the 1982 minimum interest owed JPII by GMS.

In 1981, a receivable was created in favor of MWL by Bard I in the amount of $12,000 with the same interest provisions as above. This receivable resulted from overpayments by MWL to Bard I. At the end of 1983, the balance owing on the receivable was $17,048.26. This amount was then used as an offset to the 1983 minimum interest owed Bard I by MWL.

In 1981, MBL loaned Century $25,000 for which Francoeur, as president of Century, executed a demand note in favor of Managed Investments, Inc., Chiesa's company. The note provided that in the event that the balance due was not paid on demand, interest would be added at a rate of 15 percent per annum. The note did not provide for the payment of any other amounts as interest.

Distribution Efforts

Because of his lack of experience in the area, petitioner relied on the advice of others, primarily Scheer,

with respect to distribution strategy and the choice of distributors. Petitioner had a clear understanding prior to the start-up of the partnerships that Scheer and Century would take the responsibility for placing the shows in distribution. In fact, each of the distribution contracts executed by the partnerships was negotiated by Scheer or another agent of Century.

Initially, the distribution contracts entered into by the partnerships were nonexclusive arrangements. Scheer negotiated nonexclusive contracts for two reasons: (1) he had been advised that if an exclusive distribution contract were executed and the distributor failed to make money, the partnership involved could lose its investment tax credit; and (2) Scheer considered himself to be an amateur in the distribution business and therefore wished to have flexibility with respect to the distribution contracts he negotiated for the partnerships.

Memoirs and Geppetto's were initially to be distributed by Solaris International Distributors, Inc. (SID), a wholly-owned subsidiary of Solaris, pursuant to a nonexclusive distribution contract. Neither SID nor Solaris, however, had any previous experience distributing television series. SID attempted to find responsible syndicators to aid it in distributing the series, but the decision was eventually made by Solaris personnel that SID was not reasonably equipped to accomplish television distribution. No actual marketing of Memoirs or Geppetto's was ever accomplished by SID.

Prior to 1982, the partnerships entered into distribution contracts with the following distributors:

Date	Partnership	Distributor
2/19/80	CFL	Videotheque Entertainment Corp.
11/1/80	CFL	Joseph Green Pictures
4/—/81	CFL	Telepictures Corporation
11/2/81	CFL	Cinaco Television Company
2/19/80	GMS	Videotheque Entertainment Corp.
11/1/80	GMS	Joseph Green Pictures
4/—/81	GMS	Telepictures Corporation
11/2/81	GMS	Cinaco Television Company
3/9/81	MWL	Videotheque Entertainment Corp.
10/21/81	MBL	Videotheque Entertainment Corp.

Each of the above contracts granted certain distribution rights to the distributor in exchange for the distributor's agreement to pay over to the partnership a specified percent of the distributor's gross receipts or gross income from distribution of the production.[20] The contracts required nothing more of the distributors than that they act in good faith or with best efforts in pursuing the distribution of the products.

In 1982, distribution contracts were entered between CFL and Century Home Video (CHV) and between GMS and CHV with respect to the distribution of Memoirs and Geppetto's in the home video market. CHV was a new

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[20] Several of the contracts did not require payments to the partnerships until after the distributor had recouped his expenses associated with distribution.

distribution company incorporated by the principals of Century and 50 percent owned by Scheer. These contracts gave CHV exclusive worldwide rights to the distribution of Memoirs and Geppetto's in the home video market for a period of 20 years. As executed by petitioner, however, these contracts purported to forbid CFL or GMS from bringing any action or proceeding against CHV based on a claim that CHV had not properly distributed the productions. The contracts also gave CHV the right to execute further distribution contracts without the approval of petitioner.

Contracts identical to the CHV contracts were also executed in 1982, between MWL and Bard Home Video (BHV) and between MBL and BHV. BHV was another distribution company incorporated by the principals of Century.

Income Projections

Merry Wives was the only production which petitioner had reviewed by an appraiser prior to entering into the acquisition agreement for the production. Merry Wives was also the only production which was in its finished form and which petitioner viewed prior to its acquisition. The appraisal report was done by Toluca Productions and signed by Bill Eliscu. It was dated May 30, 1980. The report predicted that in the following 5-year period Merry Wives would generate $5,100,000 in gross receipts, broken down as follows:

Commercial U.S. Television	
First Runs	$ 600,000
Reruns	700,000
Foreign Television	650,000
Cable Television	1,000,000
Closed Circuit Television	250,000
Educational Market	400,000
Prerecorded Videotapes and Discs	1,700,000
Total	$5,100,000[21]

Eliscu based his estimate of U.S. commercial television receipts on an assumption that six percent of the U.S. commercial television stations would air the play, paying an average of $10,000 for a first run and airing it again once every two years at a lesser rental. The basis for assuming a six percent market penetration and a $10,000 average first run rental fee was not explained. The foreign television revenues were assumed to be 50 percent of the total U.S. commercial television revenues. Similarly, the only bases stated for the estimate of cable television revenues were that this medium was the fastest growing of any and that the revenues it would produce should almost equal revenues from commercial television. The basis for the estimate of closed circuit television revenues was also stated to be the rate of growth of the medium.

The estimated revenues from the educational market were stated to result from the fact that Shakespeare plays were well suited to the market and that there were more than 100,000 libraries, high schools, and junior and senior colleges to which videotapes, videodiscs and motion picture films could be sold. The estimate of revenues from

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[21] The report showed the sum of these numbers to be $5,100,000, while the actual sum is $5,300,000.

the sale of videotapes and videodiscs stated that this market should be sufficiently developed by late 1982 for Merry Wives to begin selling and that by the end of 1985 revenues should equal $1,700,000. This estimate was based on 1,000,000 videotapes and videodiscs being sold for a retail price of $15 to $20 each, and a royalty to the owner of 10 percent of the retail price.

The report consisted of two typed pages and did not estimate the fair market value of Merry Wives.

Operating Results

During the years in issue, the partnerships reported the following losses on their partnership tax returns:

	1979	1980	1981
CFL	241,020	791,551	617,685
GMS	120,677	881,243	468,981
MWL	–	479,978	583,125
MBL	–	–	400,806

Distribution of Memoirs and Geppetto's returned income to their respective partnerships during the period 1979 through 1984 totalling $5,000 to $10,000. Distribution of Macbeth during the period 1981 through 1984 returned income to MBL totalling $3,000 to $4,000. Through 1984, MWL had not received any income from the distribution of Merry Wives.

During 1983 or 1984, each of the partnerships had fallen in arrears on minimum interest payments. While the notes provided that a default on minimum interest payments allowed the holder of the note to accelerate the partnerships' liability for the unpaid principal, such

action had not been taken against any of the partnerships and Scheer did not intend to take such actions against the partnerships.

OPINION

A. Economic Substance

The first issue for our consideration is whether the transactions between the partnerships, executive producers, and producers were tax shams lacking economic substance.

Transactions which are entered solely for the purpose of obtaining tax benefits and which are without economic substance are considered shams for Federal income tax purposes and will not be given effect. *Knetsch v. United States*, 364 U.S. 361 (1960); *Falsetti v. Commissioner*, 85 T.C. 332 (1985). The economic substance of a transaction, not its form, is controlling. *Gregory v. Helvering*, 293 U.S. 465 (1935). We have defined " 'sham in substance' as the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits." *Falsetti v. Commissioner, supra* at 347. In *Falsetti*, we viewed the totality of facts and circumstances as establishing that a purported purchase of real property was in substance a sham. In determining that the purchase lacked the requisite economic substance, we took into consideration the absence of indicia of arm's-length dealing, drastically inflated sales prices, and a complete disregard of contractual terms.

Respondent contends that there was no justification for the partnerships' acquisitions of the videotapes other

than expected tax benefits. Respondent alleges that prior to the transactions, petitioner failed to take the steps a prudent businessman would take prior to making a purchase for more than $2,000,000, and that his actions were those of a tax shelter promoter trying to document and substantiate transactions in the event of an Internal Revenue Service examination. Respondent further alleges that the purchase price was inflated and the result of a lack of arm's-length negotiations, and that, if the notes failed to convert to nonrecourse by their maturity dates, the parties did not intend to enforce them.

Conversely, petitioner asserts that the structure of the purchases by the partnerships has economic substance in that the purchases were not motivated solely by tax avoidance purposes. The burden is upon petitioner to prove this assertion. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). Petitioner must demonstrate that the purchases here in issue were in fact made with the intent of acquiring a profit generating property for shich notes would be executed and enforced in accordance with their terms. Absent such a showing, these transactions can be viewed as merely an attempt by the partnerships to obtain a $2,300,000 depreciable tax basis ($2,320,000 in the case of MWL), yearly interest deductions for 7 years, and investment tax credits in exchange for the payment of $230,000 in year 1 ($250,000 for MWL and $270,000 for MBL) and a payment of $52,000 in each of the following 7 years.

We find that the purchases of the videotapes in this case were completely lacking in economic substance and cannot be recognized for Federal tax purposes. While our conclusion that these transactions were in substance

shams is based on a careful review of the entire record, we find the following factors, taken together, to be particularly determinative in reaching this conclusion:

1. Arm's-Length Dealings

From the record, it is indisputable that the partnerships here involved did not attempt to negotiate for a purchase price which was less than the $2,300,000 price ($2,320,000 in the case of MWL) set by Scheer. Petitioner has not argued to the contrary. Rather, petitioner argues that the purchase price for each of the videotapes was reasonably based on the costs of production as negotiated by Scheer.

We do not believe that petitioner attempted to determine, nor that he was capable of determining, whether the purchase prices were reasonable. Prior to becoming a general partner in the partnerships here involved, petitioner had no experience in the managing of a limited partnership, the production of videotapes or the distribution of videotapes. The creation of tax oriented investments for the financing of videotaped production was on ongoing activity of Century and Solaris. Petitioner was brought into this activity solely because of his ability to obtain investors. Scheer controlled the structuring of the transactions, the choice of production arrangements, and the distribution of the productions, while petitioner's involvement, other than obtaining investors in exchange for general partner's fees and sales commissions, was token.

Further, while petitioner claims that the purchase prices for the videotapes were based on "capitalizing" the

estimated cash costs of production, the only preproduction cost estimates which have been offered as evidence were based on the use of deferred obligations to cover a large portion of the production costs. The Solaris cost estimates were prepared by taking the production order subcontract price and allocating it to the various cost categories by the use of "accountant's license." The cost estimates did not allocate any amount to Solaris' profit margin, even though the cost schedules prepared by Solaris after the productions were completed show that its profit margin was nearly $600,000 per production. The solaris cost estimate for Memoirs and the Solaris and Century cost estimates for Geppetto's were each dated later than the dates upon which petitioner signed the acquisition agreements on behalf of the partnerships. In addition, even if petitioner had received estimates of the cash costs of the productions prior to executing the acquisition agreements, he could not have determined whether the estimates were reasonable without the aid of someone more experienced in the industry.

Even though he argues that such costs were the basis for each of the partnerships' $2,300,000 purchases, there is no credible evidence in the record that petitioner attempted to independently determine what reasonable production costs for the videotapes would have been if based on the use of cash only. Further, petitioner's claim that $725,000 was a reasonable estimate of the cash cost of producing each of the videotapes is contradicted by respondent's expert on the production of videotapes,

Adrian H. Joseph.[22] Joseph was president of Ultimate Video, Inc., a full service teleproduction company and previously had 13 years experience as a producer and associate producer of programming while employed by network-owned television stations. Joseph also acted as a freelance producer and writer of television programs and video products. In his expert witness report, Joseph estimated reasonable budgets for the production of the videotapes here in issue at the times they were produced, including in each case a 15 percent contingency amount, to be as follows:

Production	Budget
Memoirs	$222,846
Geppetto's	225,628
Merry Wives	317,877
Macbeth	371,605

In conjunction with this, we note that although 2 of the productions were 13 episode children's series and 2 were Shakespearean plays and the record shows that their production arrangements differed sbustantially, the purchase price for each was virtually identical. This is clearly indicative of transactions that have been contorted to fit into standardized tax model rather than being structured to fit economic realities and which are the result of

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[22] Petitioner introduced the testimony of an expert witness, Warren Baker, on the subject of all cash production costs, but did not introduce an expert's report. Baker's testimony as to the all cash production costs was based on his view of what the production arrangements actually were as established by the evidence received at trial up to the time of his testimony we find this testimony to be extremely speculative in nature and of little value.

a single individual's controlling both sides of the transactions.[23]

In sum, a close examination of the record reveals a complete lack of arm's-length dealing with respect to the contracts entered into by the partnerships, and we therefore do not believe that from an economic standpoint they can be relied on to accurately characaterize the nature of the transactions here under consideration. See *Karme v. Commissioner*, 73 T.C. 1163, 1186 (1980), affd. 673 F.2d 1062 (9th Cir. 1982).

2. The Partnership Notes

a. Terms of the Notes

Petitioner argues that the purchase price of each of the productions was predicated upon an estimated cash cost of $725,000 per production. Petitioner alleges that this was a reasonable estimate of the cash payment that would have been required to produce each of the productions without the use of deferred obligations.[24] Petitioner further alleges that the face amount of each of the notes executed by the partnerships was determined by (1) subtacting the down payment from $725,000 to determine the amount to be deferred, (2) calculating the future value of this deferred amount in 7 years using a 20 percent annual interest rate and (3) increasing this future value by approximately 25 percent, as the executive producer's

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[23] See *Pittler v. Commissioner*, T.C. Memo. 1986-320.

[24] As we stated above, the record does not indicate that petitioner attempted to determine the reasonable costs of production prior to executing the acquisition agreements.

profit margin. For Memoirs, this calculation can be illustrated as follows:

Cash cost	$725,000
Amount deferred	725,000 – 230,000 = 495,000
Future value of amount deferred	1.20 x 495,000 = 1,773,585
Increased by 25 percent	1.20 x 1,773,585 = 2,216,981
Actual face amount of note	2,070,000

Petitioner also alleges that at the time each of the partnerships entered into its acquisition agreement, an annual interest rate of 20 percent was reasonable.

Accepting, arguendo, petitioner's assertions that $725,000 was a reasonable estimate of the cash cost of each of the productions and that 20 percent was a reasonable interest rate, petitioner has completely ignored the effect of the nine percent interest which was applied to the face amount of the notes. The result of applying a nine percent interest rate to a principal amount determined by petitioner's method is the equivalent of paying an effective minimum annual interest rate of approximately 52 percent on the deferred portion of the cost of the production. Assuming an amount to be deferred of $1 and that the principal amount of the note remains unpaid until the end of the note's term, this can be illustrated as follows:

Amount deferred	$1
Future value of amount deferred	$1.20^7 \times 1 = 3.58$
Effective annual interest	$(0.09 \times 3.58) + 0.02 = 0.52$
Effective annual interest rate	52%

If principal is paid before the end of the note's term, the effective interest rate paid on the deferred protion of

the production costs increases. In the extreme case, where the entire principal is paid in a lump sum at the end of the first year, the effective interest rate paid of the deferred portion of the production costs would be approximately 290 percent. Using the same figures as above, this can be illustrated as follows:

Amount deferred	$1
Face amount of note	3.58
Payments made at end of year	(0.09 x 3.58) + 3.58 = 3.90
Payments made in excess of amount deferred	3.90 – 1 = 2.90
Effective interest rate	290%

In choosing the form of the notes that the partnerships would execute, Scheer set the principal amounts of the notes so as to create a 20 percent annual rate of return over 7 years absent any interest accruing on the principal. Scheer then however, applied a nine percent interest rate to the principal of the notes, resulting in the partnerships being obligated to pay the equivalent of at least a 52 percent interest rate. We find it is extremely difficult to believe that any investor would be willing to pay the equivalent of a 52 percent interest rate on an investment entered into for economic reasons. Petitioner has not, however, disputed any of the facts that would lead to the conclusion that if the nature of the transactions here involved are accurately characterized by the documents which have been drafted to substantiate them, petitioner and the other investors would be paying the equivalent of a minimum 52 percent interest on what they claim to be the deferred portion of the production costs. We find this, in conjunction with other indicia of mischaracterization, to suggest that the substance of the transactions here

under consideration is neither accurately characterized by the documentation nor a product of economic considerations.

b. Enforcement of the notes

While the notes executed by the partnerships had apparently not converted to nonrecourse as of the time of trial the record in this case casts doubt on whether the parties intended to enforce the notes upon maturity. Because of the ongoing relationship of those within Century, Solaris, and Syntar, and their almost complete control of the form of the transactions here involved, evidence of the ability of someone not closely involved with Century, Solaris, or Syntar to enforce the partnership notes, either directly or indirectly, would constitute strong evidence of the parties' intent to have the notes enforced.

As to Memoirs and Geppetto's, the cost schedule prepared by Solaris is very informative with respect to determining the parties who held the ultimate interests in the $2,070,000 partnership obligations. Syntar had a total deferred interest in each of the productions pursuant to its consulting and licensing agreements of $573,750. Solaris' profit margin for each production, which based on the evidence must have been a deferred interest, was $591,440. The deferred portion of Century's markup on the production order subcontract prices was approximately $570,000 for each of the productions. Therefore, more than $1,700,000 (or more than 80 percent) of each of the CFL and GMS notes was ultimately obligated to either Century (or one of its wholly-owned subsidiaries),

Solaris or Syntar, and would not be enforced unless they chose to take action against the partnerships.[25]

With respect to MWL, the form of the transaction as set out in the production order subcontract was completely ignored. Rather than creating a single large obligation running from Bar I to SSA, an independent entity, much smaller obligations were executed by Bard I in favor of individuals involved in the production. Further, these obligations were not evidenced by notes for over 2 years after the completion of the videotaping of Merry Wives.

In the case of MBL, a production order subcontract was never executed and, similarly to the MWL transaction, small obligations were executed in favor of individuals rather than executing a single large obligation in favor of the production company. This included the execution of notes by Bard II in favor of regular employees of the production company as compensation for their services as employees of the production company. More significantly, the first set of notes executed by Bard II clearly stated that amounts in excess of a pro rata protion of MBL's minimum interest payments would only be paid out of revenues from distribution. There is also testimony in the record indicating that this was the understanding of individuals who received notes with respect to both Merry Wives and Macbeth.

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[25] The record does not clearly show how much of the balance of the CFL and GMS notes might also have been ultimately obligated to Century, Solaris or Syntar.

We also note that rather than have Century or Bard incur obligations to other parties based upon the partnerships' obligations, Scheer chose to interpose new corporations, funded with only $1,000 and created solely for this purpose, between each of the partnerships and any third party obligees. While this might not prevent a third party from reaching the partnership's obligation, it clearly has the potential of hindering such a party from doing so, especially where such party's claim is relatively small.

In sum, the record convincingly shows that the face amount of each of the notes was drastically inflated beyond an economically justifiable amount when considered in reference to the interest provisions of the note. The record also casts doubt on whether the parties intended to enforce the notes in accordance with their terms. These facts are further evidence that the transactions here under consideration were not structured with the intent of conforming to economic realities but rather were entered in order to obtain tax benefits.

3. The Offering Memoranda

The offering memoranda uniformly failed to make any representations about the fair market values of the videotapes or the income streams which could be expected to result from exploitation of the videotapes. Each of the memoranda, however, devoted in excess of 14 pages to the tax aspects of investment in the partnerships. In fact, the most direct statement made in the memoranda concerning the benefits which could be expected to result from an investment in the partnership

was "that the relative financial benefit of an investment in the partnership will generally depend substantially on the tax bracket of the investor." In addition, the portion of the memoranda which explained the requirement that the limited partners assume liability for a pro rata portion of the partnership notes was part of the section of the memoranda which explained the "at risk" rules. Section 465. The memoranda also noted as risk factors the lack of experience of almost everyone involved with the management of the partnerships, the production of the videotapes and the distribution of the videotapes.

Viewing each of the memoranda as a whole, it is unfathomable that a reasonable person could believe that there was a basis for investing in the partnerships other than for the acquisition of tax benefits.

4. Appraisals Received by Petitioner

Merry Wives was the only production which petitioner had reviewed by an appraiser prior to entering into the acquisition agreement for the production. Because petitioner chose not to have Eliscu, the preparer of the appraisal report, testify as to his credentials and background, the report was offered at trial solely for the prupose of showing petitioner's due diligence in investigating the purchase of the videotape, and not as proof of the value of the videotape. The appraisal report, however, fails to show due diligence on the part of the petitioner.

The report's explanation of the $5,100,000 revenue projection is insufficient to justify reliance on it by any prudent investor. The stated basis consisted of vague

assertions about market penetration and market growth, unsupported by relevant statistics or comparison to the results of similar productions. While purportedly relied on to jusify a more than $2,000,000 purchase, the report was only two pages and did not estimate the fair market value of the videotape. Further, petitioner has not alleged that the report was made available to investors, or potential investors, in MWL as a representation of the likely performance of the investment. We believe this to be indicative of petitioner's confidence in the report.

5. Appraisals Prepared for Trial

Respondent offered the reports and testimony of two experts who examined the four productions here under consideration. Respondent's expert James A. Sowards estimated the fair market value of each of the productions as of the dates that the acquisition agreement for each was executed. Sowards determined the following fair market values:

Production	Value as of	Value
Memoirs	10/4/79	$179,728
Geppetto's	10/4/79	179,728
Merry Wives	12/31/80	152,755
Macbeth	10/21/81	152,755

Respondent's expert A. Frank Reel also valued each of the productions as of the acquisition dates. Reel determined the following fair market values:

Production	Value as of	Value Range
Memoirs	October 1979	$ 97,500 to $130,000
Geppetto's	October 1979	130,000 to $162,500
Merry Wives	December 1980	26,000 to $32,000
Macbeth	October 1981	25,000 to $35,000

Petitioner's expert on distribution of video products, Raymond Markman, testified as to the revenues that could be generated by the productions during the 5-year period following trial. Markman testified that each of the children's series could generate $4,000,000 in wholesale home video revenues and $1,000,000 in television revenues over the 5-year period. Markman testified that the Shakespearean plays would each produce $10,000,000 in wholesale revenues over the 5-year period.

In evaluating the testimony of Markman, it is difficult not to reflect back on the performance of the production and of the partnerships up to the time of trial. During the distribution periods prior to 1984, which ranged from 3 to 5 years for each production, the productions returned the following amounts of income to their respective partnerships:

Production	Total Income
Memoirs	$5,000 to $10,000
Geppetto's	5,000 to $10,000
Merry Wives	0
Macbeth	3,000 to $4,000

During the years in issue, the partnerships generated the following tax losses:

Partnership	Years	Total Tax Losses
CFL	1979 to 1981	$1,650,256
GMS	1979 to 1981	1,470,901
MWL	1980 to 1981	1,063,103
MBL	1981	400,806

Nonetheless, we believe that it is unnecessary for us to attempt to resolve the conflicts which exist between the opinions of the experts and between these opinions

and other evidence which has been presented. Petitioner has admitted to facts which clearly establish that the prices paid for the videotapes were substantially inflated. The record unambiguously shows that the terms of the purchases were the result of a complete lack of arm's-length dealings and that Scheer possessed control of the structuring of the transactions and the ongoing operation of the partnership. The record also calls into doubt whether the parties intended to enforce their agreements in accordance with the terms set out therein. The totality of facts and circumstances establish that the purchase transactions here in issue were in substance shams lacking economic significance beyond expected tax benefits. *Falsetti v. Commissioner*, 85 T.C. 332 (1985).

Accordingly, it is unnecessary for us to reach the remaining issues other than the applicalility of section 6621(d).

B. Section 6621(d)

By an amendment to answer, respondent has raised the applicability of section 6621(d) to the portion of the underpayments attributable to the partnerships' basis overstatements.[26]

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[26] In his amended answer, respondent also raised the applicability of section 6621(d) to any portion of the underpayment attributable to "any loss disallowed by reason of section 465(a)." Section 6621(d)(3)(A)(ii). We did not reach the applicability of section 465(a) in this case, and because of respondent's failure to brief the applicability of section 6621(d), we will not consider its application beyond the narrowest scope raised in his amended answer.

Section 6621(d) provides for an increase in the rate of interest payable under section 6601 with respect to a "substantial underpayment" (defined as an underpayment in excess of $1,000) attributable to a tax motivated transaction.[27] Section 6621(d)(3)(A) enumerates types of transactions which are to be considered "tax motivated transactions." These transactions include "any valuation overstatement (within the meaning of section 6659(c))." Section 6621(d)(3)(A)(i). A valuation overstatement, within the meaning of section 6659(c), has occurred "if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)."

Each of the partnerships here in issue claimed a basis in depreciable purchased property of $2,300,000 ($2,320,000 in the case of MWL) and claimed deductions and investment tax credits as a result. Our holding that each of the purchases was in substance a sham is also a determination that each partnership's correct basis in the property was zero. As such, a valuation overstatement within the meaning of section 6659(c) has occurred to the extent of the full basis claimed by each of the partnerships, and the underpayments which are attributable to all deductions and credits resulting from the claim of basis in the purchased property are attributable to tax

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[27] The provision is applicable to transactions entered into prior to its enactment, but the additional interest only accrues after December 31, 1984. *Solowiejczyk v. Commissioner*, 85 T.C. 552 (1985), affd. without published opinion 795 F.2d 1005 (2d Cir. 1986).

motivated transactions. *Zirker v. Commissioner,* 87 T.C. No. ___ (1986). Further, for each of the years in issue, the underpayment resulting from petitioner's share of such deductions and credits is in excess of $1,000 and is therefore a "substantial underpayment." Application of the rate provided by section 6621(d) shall be made in the amount of the substantial underpayment determined pursuant to Rule 155 in accordance with Temporary Regulation section 301.6621-2T, Proceed. & Admin. Regs., 49 Fed. Reg. 50391 (Dec. 28, 1984).

Accordingly, in order that the parties may calculate the portion of the underpayment to which section 6621(d) is applicable for each year in issue,

Decisions will be entered under Rule 155.

(2)

No. 88-1142

Supreme Court, U.S.
FILED
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JOSEPH F. SPANIOL, JR.
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1988

JAMES HELBA, JR., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

WILLIAM C. BRYSON
Acting Solicitor General
JAMES I.K. KNAPP
Acting Assistant Attorney General
GARY D. GRAY
Attorney

Department of Justice
Washington, D.C. 20530
(202) 633-2217

QUESTION PRESENTED

Whether the courts below correctly determined that certain partnership purchase transactions lacked economic significance beyond expected tax benefits and hence should not generate those tax benefits.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	1
Argument	5
Conclusion	11

TABLE OF AUTHORITIES

Cases:

Berenyi v. *Immigration Director*, 385 U.S. 630 (1967) 7
Boyter v. *Commissioner*, 668 F.2d 1382 (4th Cir. 1981) .. 6
Bridges v. *Commissioner*, 39 T.C. 1064, aff'd, 325 F.2d 180 (4th Cir. 1963) 10
Collins v. *Commissioner*, 857 F.2d 1383 (9th Cir. 1988) .. 7
Frank Lyon Co. v. *United States*, 435 U.S. 561 (1978) ... 6
Knetsch v. *United States*, 364 U.S. 361 (1960) 6, 7
Mahoney v. *Commissioner*, 808 F.2d 1219 (6th Cir. 1987) 6
Rice's Toyota World v. *Commissioner*, 752 F.2d 89 (4th Cir. 1985) 6, 9, 10
Roe v. *Commissioner*, 52 T.C.M. (CCH) 778 (1986), aff'd, 841 F.2d 394 (5th Cir. 1988) (Table) 10
Sochin v. *Commissioner*, 843 F.2d 351 (9th Cir. 1988), cert. denied, No. 87-2026 (Oct. 3, 1988) 6
Tiffany Fine Arts, Inc. v. *United States*, 469 U.S. 310 (1985) 7
United States v. *Reliable Transfer Co.*, 421 U.S. 397 (1975) 7

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OPINIONS BELOW

The judgment order of the court of appeals (Pet. App. 2-3) is reported at 860 F.2d 1075 (Table). The opinion of the Tax Court (Pet. App. 12-62) is reported at 87 T.C. 983. The supplemental opinion of the Tax Court (Pet. App. 5-10) is reported at 54 T.C.M. (CCH) 900.

JURISDICTION

The judgment of the court of appeals was entered on September 9, 1988. On November 28, 1988, Justice Brennan extended the time for filing a petition for a writ of certiorari to and including January 7, 1989. The petition was filed on January 6, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a financial planner. In 1978, he met with Lawrence Scheer, founder of Century Video Corporation (Century), to discuss investing in videotapes. The

following year, petitioner recommended to his financial planning clients the purchase of master video recordings marketed by Century for reproduction and distribution. None of the master videotapes sold by Century, including those sold to petitioner's clients, has ever returned any income to its individual investors. Pet. App. 14-17.

During the period from 1979-1981, petitioner formed four partnerships to purchase master videotapes from subsidiaries of Century and of Bard Productions, Ltd. (Bard), another company formed by Scheer. Two of the partnerships bought children's television series consisting of 13 episodes. The other two partnerships each purchased a videotaped production of one of William Shakespeare's plays. Pet. App. 27-29. Each purchase transaction followed a model developed by Scheer, in which the stated price was set without negotiations at either $2,300,000 or $2,320,000. Each partnership paid roughly 10% of the stated purchase price in cash and gave the Century or Bard subsidiary a note for the balance. The limited partners contributed cash to the partnership and executed agreements that made them personally liable for a pro rata portion of the partnership note. The agreements provided that the liability of the limited partners would terminate upon the occurrence of specified contingencies, which related to the number of video cassette and video disk players purchased in the United States and the amount of revenues generated by the tape. Pet. App. 17-19, 30-31.

The partnership notes were nearly identical in all material respects. The outstanding principal on each note, together with accrued but unpaid interest, was payable on February 1 of the eighth year following the year in which the note was executed. The notes bore stated interest at a rate of nine percent; interest in excess of $52,000 per year could be accrued and added to principal. The effective interest rate was considerably higher than nine percent, how-

ever, because of the manner in which the principal amount was calculated. The principal amount of the note was not simply the estimated cost of production minus the cash down payment; instead, that deferred amount was increased by capitalizing it at an annual interest rate of 20%, and this "capitalized" amount in turn was increased by approximately 25% in order to provide the seller with a further profit. Pet. App. 18-19. The result was that, although the estimated cost of each production was $725,000 and a cash down payment of at least $230,000 was made in each case, the principal amount of the note in each case exceeded $2 million. See *id.* at 19, 30.[1] Thus, the arrangement provided for the payment by the partnerships of amounts that were equivalent to an effective rate of interest on the deferred portion of the estimated cost of the production far higher than the stated rate of interest on the notes. See *id.* at 52.[2]

Each partnership offering memorandum stated that investment in the partnership was suitable for persons in the 50% tax bracket, explaining that the "relative financial benefit of an investment in the Partnership will generally

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[1] The $725,000 figure for the estimated cost of production did not represent actual cash outlays for the production of the videotapes. The producer paid for the cost of the production with "minimum cash payments and deferred obligations" (Pet. App. 18), which took the form of notes payable in part out of the revenues from distribution (*id.* at 55).

[2] Because the notes provided for annual payments of no principal and less than all interest due, the calculation of an effective interest rate is not a simple one. The Tax Court computed the effective interest rate at 52% (Pet. App. 52-53). In the court of appeals, the government argued that the effective rate was 29% and petitioner argued that it was "only" 26% (see Pet. 19). At all events, the partnership notes bore interest at an effective rate well above the 9% stated interest rate, as well as the 20% rate that petitioner contended in the Tax Court was "reasonable" for the period in question (see Pet. App. 52).

depend substantially on the tax bracket of the investor" (Pet. App. 20). Although the offering memoranda extensively discussed the tax implications of the investment, they did not represent that the purchase price reflected the fair market value of the videotapes or that the projected production cost was a reasonable one (*id.* at 22-23). The memoranda disclosed that the general partners lacked experience both in acting as general partners of a limited partnership and in videotape production, distribution and exploitation. The memoranda explained that the general partners would rely substantially on the efforts of the executive producers and distributors of the videotapes, but noted that they also were inexperienced. *Id.* at 25-26.

2. During the years 1979, 1980, and 1981, the partnerships reported annual losses ranging from $120,667 to $881,243. The partnerships that invested in the children's series received income during the years 1979-1984 totalling between $5,000 and $10,000. One of the partnerships that purchased a videotape of a Shakespeare play received distribution revenues totalling between $3,000 and $4,000 during 1981-1984. The other partnership that invested in a Shakespeare videotape received no income through 1984. Pet. App. 45.

During 1983 and 1984, each of the partnerships fell in arrears on minimum interest payments due under the notes. Although the notes provided that such a default allowed the holders of the notes to accelerate the partnerships' obligations for unpaid principal, the obligations had not been accelerated, and Scheer did not intend to cause Century or Bard to accelerate the notes. Pet. App. 45-46.

3. As a partner in each of the partnerships, petitioner reported his distributive share of losses and investment tax credits on his 1979, 1980, and 1981 federal income tax returns. The Commissioner determined deficiencies in petitioner's taxes for those years based largely on the

denial of these claimed losses and credits. Petitioner sought redetermination of the deficiencies in the Tax Court.

After a lengthy trial, the Tax Court ruled for the government (Pet. App. 12-62). The court found that the purchase transactions were shams, "completely lacking in economic substance" (*id.* at 47), and accordingly it denied the claimed tax benefits related to the transactions (*id.* at 46-60). The court identified several facts that supported this conclusion: that there was no arm's-length bargaining and the investors did not attempt to determine whether the prices they were paying were reasonable (*id.* at 48-51); that the terms of the notes amounted to an effective interest rate on the actual investment well in excess of what any reasonable investor would pay on an investment entered into for economic reasons (*id.* at 51-54); that the terms of the notes were not enforced (*id.* at 54-56); and that the offering memoranda were so dominantly focused on tax considerations that "it is unfathomable that a reasonable person could believe that there was a basis for investing in the partnerships other than for the acquisition of tax benefits" (*id.* at 57). Thus, the Tax Court concluded that "[t]he totality of facts and circumstances establish that the purchase transactions here in issue were in substance shams lacking economic significance beyond expected tax benefits" (*id.* at 60). The court of appeals affirmed in a judgment order "essentially for the reasons set forth" by the Tax Court (*id.* at 2).

ARGUMENT

Petitioner contends (Pet. 19-26) that the courts below erred in finding that the videotape purchase transactions lacked economic substance. This contention is without merit. The evidence fully supports the conclusion of the

courts below. Moreover, that conclusion is entirely fact-bound, and it presents no issue warranting review by this Court.

1. Petitioner mistakenly contends (Pet. 19-23) that the Tax Court, affirmed by the Third Circuit, has unduly "expanded" the economic substance doctrine beyond the scope permitted by this Court. The cases cited by petitioner, *Knetsch* v. *United States,* 364 U.S. 361 (1960), and *Frank Lyon Co.* v. *United States,* 435 U.S. 561 (1978), do not purport to articulate a rigid test by which to measure whether transactions have economic substance or to hold that the doctrine can be applied only in factual situations closely analogous to the ones presented in those cases. Rather, where a court determines that the transaction in question was not designed to "appreciably affect * * * [the taxpayer's] beneficial interest except to reduce his tax" (*Knetsch* v. *United States,* 364 U.S. at 366), the transaction should be treated as a sham for tax purposes, and the purported tax benefits are appropriately denied.[3] This inquiry is necessarily a factual one. See, *e.g., Sochin* v. *Commissioner,* 843 F.2d 351, 355 (9th Cir. 1988), cert. denied, No. 87-2026 (Oct. 3, 1988); *Mahoney* v. *Commissioner,* 808 F.2d 1219, 1220 (6th Cir. 1987); *Boyter* v. *Commissioner,* 668 F.2d 1382, 1388 (4th Cir. 1981). On the facts here, the Tax Court correctly found that the partnerships' videotape purchases were economic shams—not

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[3] Indeed, petitioner's narrow reading of this Court's decisions is inconsistent even with the formulation of the sham inquiry in the case upon which petitioner relies most heavily, *Rice's Toyota World* v. *Commissioner,* 752 F.2d 89 (4th Cir. 1985). There, the court stated that a transaction is a sham if the court finds "that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists" (*id.* at 91).

because they were paper shuffles or "hocus-pocus" (*Knetsch,* 364 U.S. at 370 (Douglas, J., dissenting))—but because they were carried out solely to achieve tax objectives and not to generate an economic profit. See, *e.g.*, *Collins* v. *Commissioner,* 857 F.2d 1383, 1385 (9th Cir. 1988).

The bulk of petitioner's submission (Pet. 3-18) is devoted to a recitation of material in the record, based upon which petitioner asserts (Pet. 23) that his "business purposes * * * were undisputed at trial" and that he "reasonably expected to generate a profit" from the transactions. These assertions, however, are directly contrary to the Tax Court's findings that were based upon a thorough review of the voluminous record and were affirmed by the court of appeals. The Tax Court found it "unfathomable that a reasonable person could believe that there was a basis for investing in the partnerships other than for the acquisition of tax benefits" (Pet. App. 57) and that "the transactions * * * were not structured with the intent of conforming to economic realities but rather were entered in order to obtain tax benefits" (*id.* at 56). Petitioner seeks to reargue the evidence introduced at trial, and there is no reason for the Court to deviate here from its general practice of declining to review factual findings concurred in by both lower courts. See *Tiffany Fine Arts, Inc.* v. *United States,* 469 U.S. 310, 318 n.5 (1985); *United States* v. *Reliable Transfer Co.,* 421 U.S. 397, 401 n.2 (1975); *Berenyi* v. *Immigration Director,* 385 U.S. 630, 635-636 (1967).

In any event, the courts below correctly concluded that this record demonstrated that the transactions lacked economic substance. Based on its examination of the objective facts, the Tax Court correctly rejected petitioner's testimony professing his belief in the profit potential of the transactions. The evidence clearly supports the court's conclusion (Pet. App. 48-51) that the various agreements

entered into by the partnerships were not the result of arm's-length negotiations. Petitioner, who as general partner acted for the partnerships, was a neophyte in the field of video production and distribution (*id.* at 15). The promoter offered the videotapes at a fixed, non-negotiable price, and petitioner made no effort to determine whether the price had any reasonable relation to production costs or expected revenues. In fact, the prices of the products sold to each partnership were virtually identical, despite the dissimilarity of product and production arrangements. See *id.* at 48-50. As the Tax Court noted (*id.* at 50), this remarkable coincidence is "indicative of transactions that have been contorted to fit into a standardized tax model, rather than being structured to fit economic realities."

Each of the partnerships was burdened with inflated debt obligations. See Pet. App. 51-54; note 2, *supra.* Although such inflated obligations were not compelled by economic considerations, they were essential to the partnerships' tax objectives. The notes were included in the bases for depreciation of the videotapes and for investment tax credits, thereby creating the opportunity for the partnerships to return more in tax savings to the limited partners than the partners contributed in cash. Although the notes purported to represent recourse obligations, *i.e.*, obligations for which the partners would be personally liable if the partnership did not meet them, the Tax Court correctly found (*id.* at 56) that it was doubtful that the parties ever intended to enforce the notes in accordance with their terms. Although each of the partnerships had fallen in arrears on their payments under the notes, their obligations had not been accelerated, and the court found that Scheer did not intend to take such action against the partnerships (*id.* at 45-46).

Finally, the partnership offering memoranda advanced no inducement to invest in the partnerships aside from the

tax benefits. See Pet. App. 56-57. The memoranda disclosed, among other things, that the general partners, as well as the producers and distributors of the videotapes, had little or no experience in the business. The absence from the memoranda of any reason for optimism concerning the partnerships' economic prospects was fully justified: at the time of trial, none of the partnerships had returned any profits to its investors. These facts support the Tax Court's finding that the transactions lacked economic substance and were entered into for the purpose of creating tax benefits that would exceed the investor's cash outlays. There is no reason for further review of that factual conclusion.

2. Petitioner contends (Pet. 24-26) that the Court should grant certiorari here to resolve a conflict between the decision below and the Fourth Circuit's decision in *Rice's Toyota World* v. *Commissioner,* 752 F.2d 89 (1985). This contention is without merit. First, the court of appeals' unpublished judgment order in this case plainly does not adopt any legal principle that could be said to conflict with a decision of another court of appeals rendered in a completely different factual context. In any event, there is no conflict between the result in this case and that in *Rice's Toyota World;* the different results are simply a consequence of the different facts in the two cases.

In *Rice's Toyota World,* the court of appeals held that, although a computer sale and leaseback lacked economic substance, a short-term recourse note securing part of the purchase price did not. Accordingly, the court ruled that interest on the note was deductible. Petitioner contends that the courts here "ignor[ed]" (Pet. 25) the economic substance of the recourse notes in this case and that their failure to permit deducton of the interest on those notes

conflicts with the Fourth Circuit's decision in *Rice's Toyota World*. This contention is mistaken.

The Tax Court did not ignore the recourse designation of the partnership notes, but rather found that other relevant circumstances contradicted that designation. As with the purchase transaction as a whole, the substance, not the form, of the notes dictates their tax treatment. See, *e.g.*, *Bridges* v. *Commissioner*, 39 T.C. 1064, 1077, aff'd, 325 F.2d 180 (4th Cir. 1963); *Roe* v. *Commissioner*, 52 T.C.M. (CCH) 778, 797 (1986), aff'd, 841 F.2d 394 (5th Cir. 1988) (Table). Here, the Tax Court's findings fully support the conclusion that, despite the characterization as recourse obligations, there was little economic incentive for payment of the partnership notes. The note obligations were inflated, the tapes were producing no revenues for the partnerships, and, although the partnerships had fallen in arrears, Scheer brought no action to collect the amounts in default. Moreover, the courts below correctly rejected the contention (see Pet. 26) that the partnership notes had substance because they could be enforced by "literally hundreds of persons." The Tax Court found (Pet. App. 54-56) that the liability of the executive producers to third parties, who might theoretically enforce the partnership notes as third-party beneficiaries, was structured to minimize the possibility of enforcement. In sum, in contrast to the factual conclusion in *Rice's Toyota World* that the recourse note there was an "obligation of economic substance" because the investor could not "walk away without liability from the deferred principal and interest obligation" (752 F.2d at 96), petitioner failed to prove that the notes in this case had economic substance. Therefore, the courts below correctly refused to treat the notes as genuine debt.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

WILLIAM C. BRYSON
Acting Solicitor General
JAMES I.K. KNAPP
Acting Assistant Attorney General
GARY D. GRAY
Attorney

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